

Legislative Guide on Insolvency Law

Part four: Directors' obligations
in the period approaching insolvency
(including in enterprise groups)

Second edition



United Nations Commission on International Trade Law

Legislative Guide on Insolvency Law

Part four: Directors' obligations
in the period approaching insolvency
(including in enterprise groups)

Second edition



UNITED NATIONS
Vienna, 2020

Note

Symbols of United Nations documents are composed of letters combined with figures. Mention of such symbols indicates a reference to a United Nations document.

UNITED NATIONS PUBLICATION
e-ISBN 978-92-1-004806-4

© United Nations, February 2020. All rights reserved.

The designations employed and the presentation of material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

Publishing production: English, Publishing and Library Section, United Nations Office at Vienna.

Contents

	<i>Paragraphs</i>	<i>Page</i>
Introduction and purpose of part four		1
Section one		
Obligations of directors of an enterprise in the period approaching the insolvency of that enterprise		
Introduction and purpose of section one	1-3	3
I. Background	1-15	5
II. Elements of directors' obligations in the period approaching insolvency	1-44	11
A. The nature of the obligations	1-7	11
<i>Recommendations 255-256</i>		15
B. When the obligations arise: the period approaching insolvency	8-12	16
<i>Recommendation 257</i>		18
C. Identifying the parties who owe the obligations	13-16	18
<i>Recommendation 258</i>		19
D. Liability	17-35	20
<i>Recommendations 259-261</i>		26
E. Enforcement of the directors' liabilities	36-44	26
<i>Recommendations 262-266</i>		29
Section two		
Obligations of directors of enterprise group companies in the period approaching insolvency		
Introduction and purpose of section two	1-3	31

Glossary	4	32
I. Background	1-11	33
II. Elements of the obligations of directors of enterprise group members in the period approaching insolvency	1-13	37
A. The nature of the obligations	1-4	37
<i>Recommendations 267–268</i>		38
B. Identifying the persons who owe the obligations	5-8	41
C. Conflict of obligations	9-13	42
<i>Recommendations 269–270</i>		44
Annex V. Decisions of the United Nations Commission on International Trade Law, adopted on 18 July 2013 and 15 July 2019, and General Assembly resolution 68/107 B		45

**Legislative Guide
on Insolvency Law
Part four: Directors' obligations
in the period approaching insolvency
(including in enterprise groups)
Second edition**

Introduction and purpose of part four

The purpose of part four is to identify basic principles to be reflected in the law concerning directors' obligations in the period approaching insolvency. In the present second edition, an additional section has been included to address the enterprise group insolvency context. Section one addresses the key elements of directors' obligations in the period approaching insolvency. It does so in the context of an individual company when that company faces imminent insolvency, or its insolvency becomes unavoidable. Building on section one, section two addresses how some of the recommendations contained in section one could be revised for application to directors in the enterprise group insolvency context. It identifies the extent to which a director of an enterprise group member may take account of considerations beyond the enterprise group member he or she manages in the period approaching insolvency and the safeguards that should apply. It also includes additional recommendations to address situations when a director faces a conflict in discharging the obligations owed to the different enterprise group members.

Section one

Obligations of directors of an enterprise in the period approaching the insolvency of that enterprise

Introduction and purpose of section one

1. This section focuses on the obligations that might be imposed upon those responsible for making decisions with respect to management of an enterprise when that enterprise faces imminent insolvency or insolvency becomes unavoidable. The aim of imposing such obligations, which are enforceable once insolvency proceedings commence, is to protect the legitimate interests of creditors and other stakeholders and to provide incentives for timely action to minimize the effects of financial distress experienced by the enterprise.
2. The key elements of provisions imposing such obligations are addressed, including (a) the nature and extent of the obligations, (b) the time at which the obligations arise, (c) the persons to whom the obligations would attach, (d) liability for breach of the obligations, (e) enforcement of the obligations, (f) applicable defences, (g) remedies, (h) the persons who may bring an action to enforce the obligations, and (i) how those actions might be funded.
3. This section uses terminology common to other parts of the *Guide* and other insolvency texts prepared by UNCITRAL.¹ To provide orientation to the reader, this section should be read in conjunction with terms and explanations included in the glossary contained in the Introduction to the *Guide*.²

¹ Available from uncitral.un.org under “Texts and Status”.

² United Nations publication, Sales No. E.05.V.10.

I. Background

1. Corporate governance frameworks regulate a set of relationships between a company's management, its board, its shareholders and other stakeholders and provide not only the structure through which the objectives of the company are established and attained, but also the standards against which performance can be monitored. Good corporate governance should provide incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, as well as fostering the confidence necessary for promoting business investment and development. Much has been done at the international level to develop widely adopted principles of corporate governance that include the obligations of those persons responsible for making decisions concerning the management of an enterprise (in this part referred to as "directors"³) when it is solvent.

2. Once insolvency proceedings commence, many insolvency laws recognize that the obligations of directors will differ both in substance and focus from those applicable prior to the commencement of those proceedings, with the emphasis on prioritizing maximization of value and preservation of the estate for distribution to creditors. Often directors will be displaced from ongoing involvement in the company's affairs by an insolvency representative, although under some insolvency laws they may still have an ongoing role, particularly in reorganization. Part two, chapter III of the *Guide* addresses several possibilities for the role the debtor may play in the continuing operation of the business, including retention of full control, limited displacement, and total displacement (recommendation 112 and paras. 10-18). The chapter also addresses the obligations of the directors once insolvency proceedings commence (recommendations 108-114 and paras. 22-34). Recommendation 110 specifies in some detail the obligations that should arise under the insolvency law on commencement of insolvency proceedings and continue throughout those proceedings, including obligations: to cooperate with and assist the insolvency representative to perform its duties; to provide accurate, reliable and complete information relating to the financial position of the company and its business affairs; and to cooperate with and assist the insolvency representative in taking effective control of the estate and facilitating recovery of assets and business records. The imposition of sanctions

³ The question of who may be considered a director for the purposes of this part is discussed in this section below in chap. II, paras. 13-16. Although there is no universally accepted definition of the term, this part refers generally to "directors" for ease of reference.

where the debtor fails to comply with those obligations is also addressed (recommendation 114 and paras. 32-33).

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

4. A business facing an actual or imminent inability to meet its obligations as they fall due needs robust management, as often there are difficult decisions and judgments to be made that will be critical to the company's survival, with corresponding benefits to its owners, creditors, customers, employees and others. Competent directors should understand the company's financial situation and possess all reasonably available information necessary to enable them to take appropriate steps to address financial distress and avoid further decline. At such times, they are faced with choosing the course of action that best serves the interests of the enterprise as a whole, having weighed the interests of the relevant stakeholders in the circumstances of the specific case. Under some laws, those stakeholders will be the corporation itself and its shareholders. Under other laws, it may involve a broader community of interests that includes creditors. Directors concerned with personal liability and the possible financial repercussions of making difficult decisions in those circumstances may prematurely close down a business rather than seek to trade out of the problems, they may engage in inappropriate behaviour, including unfairly disposing of assets or property or they may also be tempted to resign, often adding to the difficulties that the company is facing.

5. The different interests and motivations of stakeholders are not easy for directors and managers to balance and provide a potential source of conflict. For example, shareholders of an enterprise, who typically are unlikely to share in any distribution in insolvency proceedings, are interested in maximizing their own position by seeking to trade out of insolvency or to hold out on any potential sale in the hope of a better return, especially where the sale price would cover only creditor claims and leave nothing for shareholders. Such courses of action may involve adopting high-risk strategies to save or increase value for shareholders, at

the same time putting creditors' interests at risk. Those actions may also reflect limited concern for the chances of success because of the protection of limited liability or director liability insurance if the course of action adopted fails.

6. Despite the potential difficulties associated with taking appropriate business decisions, when a company faces financial difficulties it is essential that early action be taken. Financial decline typically occurs more rapidly than many parties would believe and as the financial position of an enterprise worsens, the options available for achieving a viable solution also rapidly diminish. That early action must be facilitated by ease of access to relevant procedures; there is little to be gained by urging directors to take early action if that action cannot be directed towards relevant and effective procedures.⁴ Moreover, those laws that expose directors to liability for trading during the conduct of informal procedures such as voluntary restructuring negotiations (discussed in part one, chap. II, paras. 2-18) may operate to deter early action. While there has been an appropriate refocusing of insolvency laws in many countries to increase the options for early action to facilitate rescue and reorganization of enterprises, there has been little focus on creating appropriate incentives for directors to use those options. Often, it is left to creditors to pursue those options or commence formal insolvency proceedings because the directors have failed to act in a timely manner.

7. A number of jurisdictions address the issue of encouraging early action by imposing an obligation on a debtor to apply for commencement of formal insolvency proceedings within a specified period of time after insolvency occurs in order to avoid trading whilst insolvent. Other laws address the issue by focusing on the obligations of directors in the period before the commencement of insolvency proceedings and imposing liability for the harm caused by continuing to trade when it was clear or should have been foreseen that insolvency could not be avoided. The rationale of such provisions is to create appropriate incentives for early action through the use of restructuring negotiations or reorganization and to stop directors from externalizing the costs of the company's financial difficulties and placing all the risks of further trading on creditors.

8. The imposition of such obligations has been the subject of continuing debate. Those who acknowledge that such an approach has advantages point out that the obligations may operate to encourage directors to act prudently and take early steps to stop the company's decline with a view to protecting existing creditors from even greater losses and incoming creditors from becoming entangled in the company's financial difficulties. Put another way, the obligations may also have the effect of controlling and disciplining directors, dissuading them from embracing

⁴ It has been suggested that the dearth of cases under insolvent trading legislation in one State is because of the relative ease of access to voluntary procedures and only those companies that are hopelessly insolvent are ultimately liquidated.

excessively risky courses of action or passively acquiescing to excessively risky actions proposed by other directors because of the sanctions attached to the failure to perform the obligations. An associated advantage may be that they provide an incentive to directors to obtain competent professional advice when financial difficulties loom.

9. Those commentators who suggest that there are significant disadvantages cite the following examples. A rule that presumes mismanagement based solely on the fact of financial distress often causes otherwise knowledgeable and competent directors to leave a company, and the opportunity to reorganize that company and return it to profitability is missed. There is a possibility that directors seeking to avoid liability will prematurely close a viable business which otherwise could have survived, instead of attempting to trade out of the company's difficulties. Properly drafted provisions would discourage overly hasty closure of businesses and encourage directors to continue trading where that is the most appropriate way of minimizing loss to creditors and are more likely to balance the rights and legitimate expectations of all stakeholders, distinguishing cases of bad conduct from those involving market conditions or other exogenous factors. A further disadvantage cited is that the obligations may be regarded as an erosion of the legal status brought by incorporation, although it can be argued that limited liability should be seen as a privilege and courts have been alive to the potential for abuse of limited liability where it is to the detriment of creditors. Such obligations might also be regarded as a weakening of enterprise incentives on the basis that too much risk may discourage directors. Properly drafted provisions, however, would focus not so much on the causes of distress, but rather on the directors' acts (or omissions) subsequent to that point. Examples from jurisdictions that include such obligations in their laws suggest that only the most clearly irresponsible directors are found liable.

10. It is also said that such obligations may increase unpredictability, because liability depends on the particular circumstances of each case and also on the future attitudes of the courts. It is suggested that many courts lack the experience to examine commercial behaviour after the event and may be inclined to second guess the decisions that directors took in the period in question. However, in jurisdictions with experience of enforcing such obligations, courts have tended to defer to directors' actions, especially when those directors have acted on independent advice. A further suggestion is that there is an increased risk of unexpected liabilities for banks and others who might be deemed to be directors by reason of their involvement with the company, particularly at the time of the insolvency. It is desirable that relevant legislation provide due protection for such parties when they are acting in good faith, at arm's length to the debtor and in a commercially reasonable manner.⁵ It is also argued that imposing such obligations overcompensates creditors who are

⁵ See chap. II of this section, para. 14 below.

able to protect themselves through their contracts, making regulation superfluous. However, this approach presupposes that, for example, all creditors have a contract with the debtor, that they are able to negotiate appropriate protections to cover a wide range of contingencies and that they have the resources, and are willing and able, to monitor the affairs of the company. Not all creditors are in this position.

11. Director obligations and liabilities are specified in different laws in different States, including company law, civil law, criminal law and insolvency law and in some instances, they may be included in more than one of those laws or be split between those laws. In common law systems, the obligations may apply by virtue of common law, as well as pursuant to relevant legislation. Moreover, different views exist as to whether the obligations and liabilities of directors are properly the subject of insolvency law or company law. These views revolve around the status of the company as either solvent, which is typically covered by laws such as company law, or subject to insolvency proceedings, which is addressed by insolvency law (although there are examples where no such clear distinction can be drawn).⁶ A period before the commencement of insolvency proceedings, when a debtor may be factually insolvent, raises concerns that currently may not be adequately addressed by either company law or insolvency law. However, the imposition of obligations enforceable retroactively after commencement of insolvency proceedings may lead to an overlap between the obligations applicable under different laws and it is desirable that, in order to ensure transparency and clarity and avoid potential conflicts, they be reconciled.

12. Not only do the laws in which the obligations are to be found vary, but the obligations themselves vary: as noted above, those applicable before the commencement of insolvency proceedings typically differ from those applicable once those proceedings commence (see part two, chapter III, paras. 22-33). The standards to be observed by directors in performing their functions also tend to vary according to the nature and type of the business entity, e.g., a public company as distinct from a limited, closely held or private company or family business, and the jurisdiction(s) in which the entity operates and may also depend upon whether the director is an independent outsider or an inside director.

13. The application of laws addressing directors' obligations and liabilities are closely related to and interact with other legal rules and statutory provisions on corporate governance. In some jurisdictions, they form a key part of policy frameworks, such as those protecting depositors in financial institutions, facilitating revenue collection, addressing priorities for certain categories of creditors over others (such as employees), as well as relevant legal, business and cultural frameworks in the local context.

⁶ Recognizing this issue, the recommendations in this part adopt the flexible approach of referring to "the law relating to insolvency".

14. Effective regulation in this area should seek to balance the often competing goals and interests of different stakeholders: preserving the freedom of directors to discharge their obligations and exercise their judgment appropriately, encouraging responsible behaviour, discouraging wrongful conduct and excessive risk-taking, promoting entrepreneurial activity, and encouraging, at an early stage, the refinancing or reorganization of enterprises facing financial distress or insolvency. Such regulation could enhance both creditors' confidence and their willingness to do business with companies, encourage the participation of more experienced managers, who otherwise may be reluctant due to the risks related to failure, promote good corporate governance, leading to a more predictable legal position for directors and limiting the risks that insolvency practitioners will litigate against them once insolvency proceedings commence. Inefficient, unclear, antiquated and inconsistent guidelines on the obligations of those responsible for making decisions with respect to management of an enterprise as it approaches insolvency have the potential to undermine the benefits that an effective and efficient insolvency law is intended to produce and exacerbate the financial difficulty they are intended to address.

15. The purpose of this section is to identify basic principles to be reflected in the law concerning directors' obligations when a company faces imminent insolvency or when insolvency becomes unavoidable. Those principles may serve as a reference point and can be used by policy makers as they examine and develop appropriate legal and regulatory frameworks. Whilst recognizing the desirability of achieving the goals of the insolvency law (outlined in part one, chap. I, paras. 1-14 and recommendation 1) through early action and appropriate behaviour by directors, it is also acknowledged that there are threats and pitfalls to entrepreneurship that may result from overly draconian rules. This section does not deal with the liability of directors under criminal law, company law or tort law, focusing only on those obligations that may be included in the law relating to insolvency and become enforceable once insolvency proceedings commence.

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

A. The nature of the obligations

1. While the underlying rationale for considering directors' obligations in the vicinity of insolvency may be similar in different jurisdictions, different approaches are taken to formulating those obligations and determining the standard to be met. In general, however, laws tend to focus upon two aspects – first, imposing civil liability on directors for causing insolvency or failing to take appropriate action in the vicinity of insolvency (which under some laws might include commencing insolvency proceedings pursuant to an obligation under national law to do so – see para. 2 below) and second, once insolvency proceedings have commenced, avoiding actions taken by directors, including transactions that may have been entered into, in the vicinity of insolvency.

1. Obligation to commence insolvency proceedings

2. As noted above, some national laws impose on directors an obligation to apply for commencement of insolvency proceedings, which would include reorganization or liquidation, within a specified period of time (usually fairly short, such as three weeks) after the date on which the company became factually insolvent. Failure to do so may lead to personal liability, in full or in part, for any resulting losses incurred by the company and its creditors, and in some cases criminal liability, if the company continues to trade. This obligation is discussed in more detail in part two, chapter I, paragraphs 35-36.

2. Civil liability

3. Civil liability imposed on a director in the vicinity of insolvency is typically based on responsibility for causing insolvency or failing to take appropriate action to monitor the financial situation of the company, avoid or ameliorate financial difficulty, minimize potential losses to creditors and avoid insolvency. Liability may

arise when directors enter into transactions with a purpose other than ameliorating financial difficulty and preserving the value of the company (such as high-risk transactions or transactions that dispose of assets from the company's estate that may result in a material increase in the creditors' exposure without justification). It may also arise when the directors knew that insolvency could not be avoided or that the company could not meet its obligations as they fell due, but nonetheless continued to carry on business that involved, for example, obtaining goods and services on credit, without any prospect of payment and without disclosing the company's financial situation to those creditors. Under some laws, liability may arise when directors fail to meet various obligations, for example reporting inability to make certain payments, such as tax and social security premiums, or making a formal declaration of insolvency.

4. Directors generally might be expected in the circumstances outlined above to act reasonably and take adequate and appropriate steps to monitor the situation so as to remain informed and thus be able to act to minimize losses to creditors and to the company (including to its shareholders), to avoid actions that would aggravate the situation, and to take appropriate action to avoid the company sliding into insolvency.

5. Adequate and appropriate steps might include, depending on the factual situation, some or all of the following:

(a) Directors could ensure proper accounts are being maintained and that they are up to date. If not, they should ensure the situation is remedied;

(b) Directors could ensure that they obtain accurate, relevant and timely information, in particular by informing themselves independently (and not relying solely on management advice) of the financial situation of the company, the extent of creditor pressure and any court or recovery actions taken by creditors or disputes with creditors. Directors may need to devote more time and attention to the company's affairs at such a time than is required when the company is healthy;

(c) Regular board meetings could be convened to monitor the situation, with comprehensive minutes being kept of commercial decisions (including dissent) and the reasons for them, including, when relevant, the reasons for permitting the company to continue trading and why it is considered there is a reasonable prospect of avoiding insolvent liquidation. The steps to be taken might involve continuing to trade, as there may be circumstances in which it will be appropriate to do so even after the conclusion has been formed that liquidation cannot be avoided because, for example, the company owns assets that will achieve a much higher value if sold on a going concern basis. When the continuation of trading requires further or new borrowing (when permitted under the law), the justification for

obtaining it and thus incurring further liabilities should be recorded to ensure there is a paper trail justifying directors' actions if later required;

(d) Specialist advice or assistance, including specialist insolvency advice could be sought. While legal advice may be important for directors at this time, key questions relating to the financial position of the company are typically commercial rather than legal in nature. It is desirable that directors examine the company's financial position and assess the likely outcomes themselves, but also seek advice to ensure that any decisions taken could withstand objective and independent scrutiny. In this instance, the directors, either collectively, as inside directors or as independent directors, may retain independent accountants, restructuring experts, or counsel to provide separate advice as to the options available to the board to determine the viability of any proposals made by management;

(e) Early discussions with auditors could be held and, if necessary, an external audit be prepared;

(f) Directors could consider the structure and functions of the business with a view to examining viability and reducing expenditure. The possibility of holding restructuring negotiations or commencing reorganization could be examined and a report be prepared. Directors may also consider the capacity of current management, with a view to determining whether it should be retained or replaced;

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

(h) Directors could ensure that the assets of the company are protected⁷ and that the company does not take actions that would result in the loss of key employees or enter into transactions of the kind referred to in

⁷ Not all assets will necessarily require protection in all circumstances. Examples of the types of asset that might not require protection in all circumstances might be those that are worth less than the amount for which they are secured, are burdensome, of no value or hard to realize (this is discussed in more detail in part two, chap. II, para. 88).

recommendation 87 that might later be avoided, such as transferring assets out of the company at an undervalue. Not all payments or transactions entered into at this time are necessarily suspect; payments to ensure the continuance of key supplies or services, for example, may not constitute a preference if the objective of the payment was the survival of the business. It is desirable that the reasons for making the payment be clearly recorded in case the transaction should later be questioned. Directors with substantial stockholdings or who represent major shareholders may not be considered disinterested or objective and might need to take especial care when voting on transactions in the vicinity of insolvency;

(i) A shareholders' meeting could be called, in the best interests of the company and without undue delay, if it appears from the balance sheet that a stipulated proportion of the share capital has eroded (generally applicable where the law includes capital maintenance requirements);

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

3. *Avoidance of transactions*

6. Recommendations 87 to 99 deal with the avoidance of transactions at an undervalue, transactions conferring a preference and transactions intended to defeat, delay or hinder creditors (see part two, chap. II, paras. 170-185). Those recommendations would apply to the avoidance of transactions entered into by a company in the vicinity of insolvency. The avoidability of a transaction does not, on its own, serve as the basis for imposing personal liability on directors.

7. However, certain avoidable transactions may also have other consequences. Some laws render certain actions of directors unlawful under, for example, wrongful or fraudulent trading provisions, or as acts having worsened the economic situation of the company or having led to insolvency, such as entering into new borrowing or providing new guarantees without sufficient business justification. In addition to the avoidance of such transactions, under some laws a director may be found personally liable for permitting the company to enter into such fraudulent or otherwise improper transactions. Liability under those provisions would typically apply only in relation to directors who agreed to the transaction; those who expressly dissented and whose dissent was duly noted are likely to avoid responsibility.

Recommendations 255-256

Purpose of legislative provisions

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

- (a) To protect the legitimate interests of creditors and other stakeholders;
- (b) To ensure that those responsible for making decisions concerning the management of a company are informed of their roles and responsibilities in those circumstances; and
- (c) To provide appropriate remedies for breach of those obligations, which may be enforced after insolvency proceedings have commenced.

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

- (a) Adversely affect successful business reorganization;
- (b) Discourage participation in the management of companies, particularly those experiencing financial difficulties; or
- (c) Prevent the exercise of reasonable business judgment or the taking of reasonable commercial risk.

Contents of legislative provisions

The obligations

255. The law relating to insolvency should specify that from the point in time referred to in recommendation 257, the persons specified in accordance with recommendation 258 will have the obligations to have due regard to the interests of creditors and other stakeholders and to take reasonable steps:

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

Reasonable steps for the purposes of recommendation 255

256. For the purposes of recommendation 255, reasonable steps might include:

- (a) Evaluating the current financial situation of the company and ensuring proper accounts are being maintained and that they are up-to-date; being independently informed as to the current and ongoing financial situation of the company; holding regular board meetings to monitor the situation; seeking professional advice, including insolvency or legal advice; holding discussions with auditors; calling a shareholder meeting; modifying management practices to take account of the interests of creditors and other stakeholders;

Recommendations 255-256 (continued)

protecting the assets of the company so as to maximize value and avoid loss of key assets; considering the structure and functions of the business to examine viability and reduce expenditure; not committing the company to the types of transaction that might be subject to avoidance unless there is an appropriate business justification; continuing to trade in circumstances where it is appropriate to do so to maximize going concern value; holding negotiations with creditors or commencing other informal procedures, such as voluntary restructuring negotiations;⁸

(b) Commencing or requesting the commencement of formal reorganization or liquidation proceedings.

B. When the obligations arise: the period approaching insolvency

8. The point at which the obligations discussed above might arise has been variously described as the “twilight zone”, the “zone of insolvency” or the “vicinity of insolvency”. Although a potentially imprecise concept, it is intended to describe a period in which there is a deterioration of the company’s financial stability to the extent that insolvency has become imminent (i.e., where the company will generally be unable to pay its debts as they mature (recommendation 15 (a)) or unavoidable. Determining exactly when the obligations arise is a critical issue for directors seeking to make decisions in a timely manner consistent with those obligations. Moreover, without a clear reference point, it would be difficult for directors to predict with confidence the point in time in the period before insolvency proceedings commence to which a court would have reference in considering an action for breach of those obligations.

9. There are various possibilities for determining the time at which directors’ obligations might arise in the period before commencement of insolvency proceedings and different approaches are taken. One possibility may be the point at which an application for commencement of insolvency proceedings is made, arguably the possibility that delivers the most certainty. If, however, the insolvency law provides for automatic commencement of proceedings following an application or the gap between application and commencement is very short (see recommendation 18), this option will have little effect in terms of encouraging directors to take early action.

⁸ See part one, chap. II, paras. 2-18.

10. Another possibility focuses on the obligations arising when a company is factually insolvent, which under some laws may occur well before an application for commencement of insolvency proceedings is made. Taking the general approach of the *Guide*, insolvency might be said to have occurred in fact when a company becomes unable to pay its debts as and when they fall due, or when a company's liabilities exceed the value of its assets (recommendation 15). A further possibility is when insolvency is imminent, i.e., where the company will generally be unable to pay its debts as they mature (recommendation 15 (a)). These tests, however, are increasingly used in insolvency laws as commencement standards and in some States form the basis for imposing an obligation on directors to apply for commencement of insolvency proceedings within a specified period of time, usually rather short, after a company becomes insolvent. Accordingly, these tests are also unlikely to encourage appropriate steps to be taken at a sufficiently early time.

11. A somewhat different approach examines the knowledge of a director at a point before commencement of insolvency proceedings when, for example, the director knew, or ought to have known, that the company was insolvent or that insolvency was imminent and there was no reasonable prospect that the company could avoid having to commence insolvency proceedings or that the continuity of the business was threatened. The rationale of this approach is to catch directors who are unreasonable in their running of a company that is experiencing financial difficulty and to provide incentives to take appropriate action at an optimal time. Although a concern with that type of standard might be the difficulty of determining with certainty the exact point at which the requisite knowledge could be imputed, provided a company's accounts have been properly kept and are accurate, a director should be able to deduce when the company is in difficulty and when it might be in danger of satisfying these insolvency tests. Alternatively, the director can be assumed to have known the information that would have been revealed had the company complied with its obligations to maintain proper books of account and to prepare annual accounts. Essentially, the standard requires a director's judgment to be assessed against the knowledge that a reasonably competent director should or ought to have had in the circumstances. Such a standard would require a wider consideration of circumstances and context, including, for example, examining the books of the company and its financial position in its entirety. It could involve looking at revenue flows and debts incurred and contingencies, including the ability to raise funds. Generally speaking, evidence of a temporary lack of liquidity would not be sufficient.

12. The recommendations do not preclude States from imposing liabilities on directors that might be enforceable outside insolvency proceedings when, due to the lack of assets to cover the costs of the proceedings, the commencement of insolvency proceedings is denied.

Recommendation 257

Purpose of legislative provisions

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

Contents of legislative provisions

The time at which the obligation arises

257. The law relating to insolvency should specify that the obligations in recommendation 255 arise at the point in time when the person specified in accordance with recommendation 258 knew, or ought reasonably to have known, that insolvency was imminent or unavoidable.

C. Identifying the parties who owe the obligations

13. In most States, a number of different persons associated with a company have obligations with respect to management and oversight of the company's operations. They may be the owners of a company, formally appointed directors, (who may be independent outsiders or officers or managers of a company serving as executive directors, referred to as "inside directors") and non-appointed individuals and entities, including third parties acting as de facto⁹ or "shadow" directors,¹⁰ as well as persons to whom the powers or duties of a director may have been delegated by the directors.

14. A broad definition may also include special advisors and in some circumstances, banks and other lenders, when they are advising a company on how to address its financial difficulties. In some cases, that "advice" may amount to determining the exact course of action to be taken by the company and making the adoption of a

⁹ A de facto director is generally considered to be a person who acts as a director, but is not formally appointed as such or there is a technical defect in their appointment. A person may be found to be a de facto director irrespective of the formal title assigned to them if they perform the relevant functions. It may include anyone who at some stage takes part in the formation, promotion or management of the company. In small family-owned companies, that might include family members, former directors, consultants and even senior employees. Typically, to be considered a de facto director would require more than simply involvement in the management of the company and may be determined by a combination of acts, such as the signing of cheques, signing of company correspondence as "director", allowing customers, creditors, suppliers and employees to perceive a person as a director or "decision maker" and making financial decisions about the company's future with the company's bankers and accountants.

¹⁰ A shadow director may be a person, although not formally appointed as a director, in accordance with whose instructions the directors of a company are accustomed to act. Generally, shadow directors would not include professional advisors acting in that capacity. To be considered a shadow director may require the capacity to influence the whole or a majority of the board, to make financial and commercial decisions which bind the company and, in some cases, that the company have ceded to the shadow director some or all of its management authority. In an enterprise group context (see section two), one group member may be a shadow director of another group member. In considering the conduct that might qualify a person to be a shadow director, it may be necessary to take into account the frequency of the conduct and whether or not the influence was actually exercised.

particular course of action a condition of extending credit. Nevertheless, provided the directors of the company retain their discretion to refuse that course of action, even if in reality they may be regarded as having little option because it will result in liquidation, and provided the outside advisors are acting at arm's length, in good faith and in a commercially appropriate manner, it is desirable that such advisors not be considered as falling within the class of person subject to the obligations.

15. There is no universally accepted definition of what constitutes a "director". As a general guide, however, a person might be regarded as a director when they are charged with making or do in fact make or ought to make key decisions with respect to the management of a company, including functions such as the following:¹¹ determining corporate strategy, risk policy, annual budgets and business plans; monitoring corporate performance; overseeing major capital expenditure; monitoring corporate governance practices; selecting, appointing, and supporting the performance of the chief executive; ensuring the availability of adequate financial resources; addressing potential conflicts of interest; ensuring integrity of accounting and financial reporting systems; and accounting to the stakeholders for the organization's performance.

16. The obligations discussed above would attach to any person who was a director at the time the business was facing actual or imminent insolvency, and may include directors who subsequently resigned (see para. 27 below). It would not include a director appointed after the commencement of insolvency proceedings.

Recommendation 258

Purpose of legislative provisions

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

Contents of legislative provisions

Persons owing the obligations

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

¹¹ These examples are provided for information and are not listed in any particular order of importance.

D. Liability

1. *The standard to be met*

17. Laws dealing with the obligations of directors in the vicinity of insolvency judge the behaviour of directors in that period against a variety of standards to determine whether or not they have failed to meet these obligations. Typically those obligations only become enforceable once insolvency proceedings commence and as a consequence of that commencement, apply retroactively in much the same way as avoidance provisions (see discussion in part two, chap. II, paras 148-150 and 152).

18. Under some laws, the question of when a director or officer knew, or ought to have known, that the company was insolvent or was likely to become insolvent is judged against the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company. More may be expected of a director of a large company with sophisticated accounting systems and procedures. If the director's skills and experience exceed those required for the job, the judgment may be made against the skills and experience actually possessed, instead of against those required for the job. In contrast, inadequate skill and experience for the job may not excuse a director and they could be judged against the skill and experience required for the job.

19. Another approach requires there to be reasonable grounds for suspecting the company was insolvent or would become insolvent at the time of incurring the debt or entering into the transaction leading to insolvency. Reasonable grounds for suspecting insolvency would require more than mere speculation and the director must have an actual apprehension that the company is insolvent. This is a lower threshold than expecting or knowing the company is insolvent. Under this approach, the standard is that of a director of ordinary competence who is capable of having a basic understanding of the company's financial status and the assessment is made on the basis of knowledge such a director could have had and not on information that might later become apparent. Empirical evidence from jurisdictions with such provisions suggests that when reviewing what occurred, often some time before the review takes place, courts have demonstrated a good deal of understanding of the position in which directors find themselves, carefully analysing the situation they confronted and demonstrating appreciation for the business issues encountered.

20. Some laws provide a safe harbour for directors, such as by way of a business judgement rule that establishes a presumption that directors have, for

example, acted in good faith and had a rational belief that they acted in the best interests of the company, that they have had no material personal interest, and that they have properly informed themselves. Provided the actions of the director were taken in good faith, with due care and within the director's authority, they will be shielded from liability. To rely upon the rule, directors must inform themselves with respect to the matters to be decided by acquiring, studying and relying upon information that a reasonable person in similar circumstances would find persuasive and be free from any conflict of interest with respect to those matters.

21. Other laws may require a causal link between the act of mismanagement and the debts arising from it or that the mismanagement is an important cause of the company's insolvency. This approach requires that a director be guilty of a fault in management when judged against the standards of a normally well-advised director. Examples of behaviour or actions that might give rise to liability under those laws include imprudence, incompetence, lack of attention, failure to act, engaging in transactions that were not at arm's length or of a commercial nature and improperly extending credit beyond the company's means, while the most common failures have involved directors permitting the company to trade while manifestly insolvent and to have embarked on projects beyond its financial capacity and that were not in its best interests. Other examples of mismanagement include: where directors have failed to undertake sufficient research into the financial soundness of business partners or other important factors before entering into contracts; where directors fail to provide sufficient information to enable a supervisory board to exercise supervision over management; where directors fail to obtain or to study management accounts; where directors neglect the proper financial administration of the company; where they neglect to take preventive measures against clearly foreseeable risks; or where bad personnel management by the directors leads to unrest and strikes. Under some laws that adopt this approach, a finding of mismanagement does not require that a director have actively engaged in the management of the company; passive acquiescence may be sufficient.

2. The nature of the liability

22. Determining whether a particular director has breached her or his obligations involves consideration of the facts regarding the conduct of that director leading up to the commencement of insolvency proceedings with respect to the debtor. Once a breach of the obligations has been determined under the relevant standard of proof, liability can be apportioned in several ways. Under one approach, liability

will be apportioned to individual directors in proportion to their specific involvement in the decisions or behaviour under examination, requiring consideration of that involvement in the totality of the circumstances. The constitution of a board of directors is an important factor in addressing these issues. Where a company has independent directors, who do not own a significant proportion of the equity and who do not represent equity-owners, such directors may not have access to information to the same extent that is known or available to inside directors. Liability may vary between inside and independent directors depending on the factual situation.

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

3. *Defences*

24. Under some laws, where directors do have obligations in the vicinity of insolvency, they may nevertheless rely on certain defences, such as the business judgment rule, to show that they have behaved reasonably. A slightly different approach gives directors the benefit of the doubt on the assumption that business risks are an unavoidable and incidental part of management. Courts are reluctant to second guess a director who has satisfied the duties of care and loyalty, or to

make decisions with the benefit of hindsight. It may also be the case that the business judgment rule provides a defence to some, but not all, of the obligations specified under the law.

25. Under some laws, directors would need to show that they had taken appropriate steps to minimize any potential loss to the company's creditors once they had concluded that the company would have difficulty avoiding liquidation. Provided directors can show that they took reasonable and objective business decisions based on accurate financial information and appropriate professional advice, they are likely to be able to rely on this as a defence even if those decisions turn out to have been commercially wrong.

26. Some laws also provide for directors to take certain procedural or formal steps to avoid or reduce their liability for decisions or actions that are subsequently called into question, such as entering a dissent in the minutes of a meeting, delivering a written dissent to the secretary of a meeting before its adjournment or delivering or sending a written dissent promptly after the adjournment of a meeting to the registered office of the corporation or other authority as provided under national law. Directors who are absent from a meeting at which such decisions were taken may be deemed to have consented unless they follow applicable procedures, such as taking steps to record their dissent within certain specified periods of time after becoming aware of the relevant decision.

27. The fact that a director has no knowledge of the company's affairs would generally not excuse failure to meet the obligations. Moreover, resignation in the vicinity of insolvency will not necessarily render a director immune from liability, as under some laws directors may leave themselves open to the suggestion that the resignation was connected to the insolvency, that they had become aware or ought to have been aware of the impending insolvency and that they had failed to take reasonable steps to minimize losses to creditors and ameliorate the situation. Where a director has dissented to a decision that is subsequently being examined, that dissent typically would need to have been recorded in order for the director to rely on it. Where a director is at odds with fellow directors over the action to be taken, and despite taking reasonable steps to persuade them has failed to do so, it may be appropriate for the director to resign, provided his or her efforts and advice are recorded.

28. Liability may be minimized through specific insurance, which may be purchased by the company for its directors, or by the use of indemnities. Where insurance is available, the principal limits are typically deliberate fraud and self-dealing, leaving directors generally covered for breach of the obligations discussed here unless the insurance coverage is inadequate, as may occur in insolvency. Once a claim has been made against a director, it may be possible under some laws to

reach a settlement through negotiation with the insolvency representative; in some jurisdictions that is the usual approach.

4. Remedies

29. Different remedies and combinations of remedies for breach of a director's obligations are provided under civil law. The remedies focus on the provision of compensation for breach of the obligation and the damage caused, although the manner of measuring quantum varies. Typically, there is no punitive damages element. A number of laws also provide for disqualification of a director from acting as a director or taking part in the running and management of a company.

(a) Damages and compensation

30. Where directors are found liable for actions or omissions in the vicinity of insolvency, the extent of liability varies. Under some laws, directors may be liable for loss or damage suffered by individual creditors and employees, as well as the company itself, where the loss is a direct result of their acts or omissions. They may also be liable for payments that result in a reduction of the insolvency estate or that have resulted in the diminution of the company's assets. Some laws permit the court to adjust the level of liability to match the nature and seriousness of the mismanagement or other act leading to liability. Some laws provide that a director can be found liable for the difference between the value of the company's assets at the time it should have ceased trading and the time it actually ceased trading. An alternative formulation is the difference between the position of creditors and the company after the breach and their position if the breach had not taken place.

31. Some laws that include an obligation to apply for commencement of insolvency proceedings or to hold a shareholder meeting where there is a loss of capital also make provision for the award of damages.

32. Where directors are found liable, the amount recovered may be specified as being for the benefit of the insolvency estate, on the basis that the principal justification for pursuing directors is to recover some of the value lost as a result of the directors' actions in the form of compensation for the estate. It is thus for the benefit of all, rather than individual, creditors. Some laws provide that where the company has an all-enterprise mortgage, any damages recovered are for the benefit of unsecured creditors. It may be argued in support of that approach that compensation should not go to secured creditors as the cause of action does not

arise until the commencement of insolvency proceedings and thus cannot be subject to a security interest created by the company prior to that point. Moreover, what is being sought is not the recovery of assets of the company, in contrast to an avoidance proceeding, but rather a contribution from directors to remedy the damage suffered by creditors. Where, however, the insolvency law permits creditors to pursue directors (see paras. 36-42 of this chapter below), there may be grounds for suggesting that any compensation to be paid might be applied, in the first instance, to cover the costs of the creditor or creditors commencing the action.

33. In addition to the above remedies, debts or obligations due from the company to directors may be deferred or subordinated and directors may be required to account for any property acquired or appropriated from the company or for any benefit obtained in the breach of the obligations.

(b) Disqualification

34. A consequence provided for under a number of laws when insolvency proceedings commence is disqualification of a director from being a director or from taking part in the running and management of a company. Such measures are typically regarded as protective measures designed to remove those directors from a position where they can cause further harm by continuing to perform management and director functions in the same or a different company. Under one law, disqualifications of between two and 15 years may be ordered where the individual is found to be “unfit” to act as a director. Factors relevant to that determination include: breach of a fiduciary duty; misapplication of moneys; making misleading financial and non-financial statements; and failure to keep proper accounts and make returns. It may also include acts relevant to the company’s insolvency, such as the person’s responsibility for the company entering into transactions liable to avoidance on grounds similar to those in recommendation 87 or the company continuing to trade when the director knew or should have known that it was insolvent. The various factors are generally considered cumulatively in determining unfitness in a specific case. In jurisdictions providing for disqualification, those persons found to be unfit often, though not always, have displayed a lack of commercial probity, gross negligence or serious incompetence.

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

Recommendations 259-261

Purpose of legislative provisions

The purpose of provisions on liability is:

(a) To provide rules for the circumstances in which the actions of a person subject to the obligations in recommendation 255 that occur prior to the commencement of insolvency proceedings may be considered injurious and therefore a breach of those obligations;

(b) To identify defences to an allegation of breach of the obligations; and

(c) To identify the consequences of that breach.

Contents of legislative provisions

Liability

259. The law relating to insolvency should specify that where creditors have suffered loss or damage as a consequence of the breach of the obligations in recommendation 255 the person owing the obligations may be liable.

260. The law relating to insolvency should provide that the liability arising from breach of the obligations in recommendation 255 is limited to the extent to which the breach caused loss or damage.

Elements of liability and defences

261. The law relating to insolvency should specify: the elements to be proved in order to establish a breach of the obligations in recommendation 255 and that, as a consequence, creditors have suffered loss or damage; the party responsible for proving those elements; and specific defences to an allegation of breach of the obligations. Those defences may include that the person owing the obligations took reasonable steps of the kind referred to in recommendation 256.

E. Enforcement of the directors' liabilities

1. Persons who may bring an action

36. A number of laws limit the right to bring an action against a director for breach of the obligations discussed above by reference to the nature of the action and the person with the power to pursue it. Considerations similar to those

applicable to the exercise of avoidance powers, addressed under recommendation 87 (see part two, chap. II, paras. 192-195) may apply.

37. A number of laws provide that when insolvency proceedings have commenced, it is only the insolvency representative who, having reviewed a director's actions prior to insolvency, has the right to proceed against the director to recover compensation for the benefit of creditors in respect of any loss caused to the company. Wrongful trading laws, for example, may permit the insolvency representative to pursue directors for contributions to the insolvency estate where their behaviour has contributed to their company's insolvency or constitutes an act of mismanagement. Some laws also permit such action to be brought by the public prosecutor or the court acting on its own motion.

38. Although a major justification for imposing obligations on directors in the vicinity of insolvency is the protection of creditor interests, not all laws permit creditors to pursue a director for breach of those obligations. Under some laws where the insolvency representative takes no action, creditors, and sometimes shareholders, may have a derivative right to bring an action (see part two, chap. II, paras. 192-195). Where the benefit of any damages assessed will accrue to the insolvency estate for the benefit of creditors, there may be little incentive for shareholders to pursue such an action. Other laws only allow creditors to pursue certain types of actions or transactions, such as misfeasance or transactions at an undervalue. Under other laws, where creditors have no independent right to pursue a claim, a single creditor can pursue a director only with the consent of the majority of creditors or the creditor committee or creditors can request the creditors' representative or committee or the court to undertake any such action.

39. Where it is deemed appropriate for the law to permit creditors to pursue directors, a distinction might be drawn between creditors whose debt arose in the period approaching insolvency as a direct result of the conduct being examined and creditors whose debt predated that period. Depending upon the applicable law relating to insolvency, an action against a director, if authorized, may be brought by the insolvency representative for the benefit of the insolvency estate. If permitted by the law relating to insolvency, an action against a director may be brought by a creditor for the benefit of the insolvency estate if the action is not brought by the insolvency representative. In some States and subject to the law relating to insolvency, an action against a director may be brought by a creditor for its own benefit. All such actions will be on the basis that the conduct being examined occurred in the vicinity of insolvency. Under some laws, that individual right of a creditor is limited to situations where the egregious behaviour in question has been directed at a particular creditor. Should it be regarded as desirable to permit creditors to pursue a director, the insolvency law as it applies to avoidance proceedings might provide a useful example of the procedure to be followed (see part two,

chap. II, paras. 192-195). The law might require, for example, the prior consent of the insolvency representative to ensure that they are informed as to what creditors propose and have the opportunity to refuse permission, thus avoiding any negative impact those actions may have on administration of the estate.

40. Where the consent of the insolvency representative or creditors is required, but not obtained or is refused, the insolvency law might permit a creditor to seek court approval to pursue a director. The insolvency representative should have a right to be heard in any resulting court hearing to explain why it believes the action should not go ahead. At such a hearing, the court might give leave for the action to be commenced or may decide to hear the case on its own merits. Such an approach may work to reduce the likelihood of any deal making between the various parties. Where creditor-initiated actions are permitted with respect to avoidance, some laws require creditors to pay the costs of those actions or allow sanctions to be imposed on creditors to discourage potential abuse of those actions; the same approach might be adopted with respect to actions brought by creditors against directors.

41. Under those laws imposing an obligation on directors to commence insolvency proceedings, the company itself, its shareholders and creditors may have a claim for damages in the event of a breach of that obligation. Where payments have been made by directors contrary to a moratorium that accompanies the obligation to commence insolvency proceedings, the company itself may have a claim for damages. The company may also have a claim under laws that impose an obligation to hold a shareholder meeting if there is a loss of capital. It is desirable that the insolvency law ensure coordination of any actions that might potentially be commenced by these different parties.

42. An action against the directors for breach of their obligations can be a significant asset of the insolvency estate and increase returns to creditors. However, in many jurisdictions, the pendency of such an action prevents the closure of an insolvency proceeding and the final distribution of proceeds. Therefore, it is desirable that before commencing an action against a director, the insolvency representative considers the likelihood of success of that proceeding as well as other circumstances such as the ability of the director to respond to an award of damages, the scope of insurance coverage available to the director, and the effect of the litigation on the duration of the insolvency proceedings.

2. *Funding of actions*

43. A potential difficulty arising in those jurisdictions that permit an insolvency representative to bring an action for breach of these obligations relates to payment of their costs in the event that it is unsuccessful. The lack of available funding is

often cited as a key reason for the relative paucity of cases pursuing the breach of such obligations. While funding might be made available from the insolvency estate when there are sufficient assets to do so, as is often the case with avoidance proceedings insolvency representatives may be unwilling to expend those assets to pursue litigation unless there is a very good chance of success (see part two, chap. II, para. 196). In many cases, however, there will be insufficient funds available in the insolvency estate to pursue a director, even if there is a strong likelihood that the litigation will be successful.

44. Devising alternative approaches to funding in such circumstances may offer, in appropriate situations, an effective means of restoring to the estate value lost through the actions of directors, addressing abuse, investigating unfair conduct and furthering good governance. Obtaining such alternative funding would be assisted by including appropriate authorization in any law relating to insolvency in much the same way as is provided by recommendation 95 with respect to the funding of avoidance proceedings. The right to commence such a proceeding, or the expected proceeds of the proceeding if successful, might be assigned for value to a third party, including creditors or a lender might be approached to provide funds. Where the cause of action is pursued by a party other than the insolvency representative in the collective interests of creditors, the costs of commencing such a proceeding might be recovered from any compensation paid. Under some laws, claims against directors might be settled through negotiation with insolvency representatives, avoiding the need to find funding. In some jurisdictions this occurs infrequently, while in others it is usual practice and insolvency representatives typically “invite” contributions from directors. As an additional issue, it may be appropriate to consider the court in which such proceedings could be commenced; this issue is discussed in part two, chapter I, paragraph 19.

Recommendations 262 - 266

Purpose of legislative provisions

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

Contents of legislative provisions

Remedies

262. The law relating to insolvency should specify that the remedies for liability found by the court to arise from a breach of the obligations in

Recommendations 262 - 266 (continued)

recommendation 255 should include payment in full to the insolvency estate of any damages assessed by the court.

Conduct of actions for breach of the obligation

263. The law relating to insolvency should specify that the cause of action for loss or damage suffered as a result of the breach of the obligations in recommendation 255 belongs to the insolvency estate and the insolvency representative has the principal responsibility for pursuing an action for breach of those obligations. The law relating to insolvency may also permit a creditor or any other party in interest with the agreement of the insolvency representative to commence such an action. Where the insolvency representative does not agree, the creditor or other party in interest may seek leave of the court to commence such an action.

Funding of actions for breach of the obligation

264. The law relating to insolvency should specify that the costs of an action against the person owing the obligations be paid as administrative expenses.¹²

265. The law relating to insolvency may provide alternative approaches to address the pursuit and funding of such actions.

Additional measures

266. In order to deter behaviour of the kind leading to liability under recommendation 259, the law relating to insolvency may include remedies additional¹³ to the payment of compensation provided in recommendation 262.

¹² For an explanation of “administrative expenses”, see the glossary in the Introduction to the *Guide*, para. 12(a).

¹³ The additional remedies that may be available will depend upon the types of remedies available in a particular jurisdiction and what, in addition to the payment of compensation, might be proportionate to the behaviour in question and appropriate in the circumstances of the particular case. Examples of such remedies are discussed in paras. 33-35 of this chapter.

Section two

Obligations of directors of enterprise group companies in the period approaching insolvency

Introduction and purpose of section two

1. This section builds upon recommendations 255 to 266 of section one, 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 adapted for application to directors¹⁴ in the context of enterprise group. Recommendations 257 to 266 of section one continue to apply in the enterprise group context, however cross- references in those recommendations to recommendations 255 and 256 should be read for the purposes of this section as references to recommendations 267 and 268 contained in this section.
2. Additional recommendations (recommendations 269 and 270) have been included in this section to address the situation where a director is appointed to, or holds a managerial or executive position in, more than one enterprise group member and a conflict arises in discharging the obligations owed to the different members.
3. This section should be read in conjunction with section one and also in conjunction with part three of the *Guide*. In addition, in 2019, UNCITRAL adopted a legislative text, the UNCITRAL Model Law on Enterprise Group Insolvency,¹⁵ which seeks to facilitate insolvency proceedings for enterprise groups. That text and its accompanying Guide to Enactment provide a framework that is intended to streamline the conduct of such proceedings and assist in the development of a group insolvency solution, including by providing a regime for cross-border recognition of group insolvency

¹⁴ The question of who may be considered a director is discussed in section one, chap. II, paras. 13-16. Although there is no universally accepted definition of the term, this section continues to refer generally to “directors” for ease of reference.

¹⁵ *Official Records of the General Assembly, Seventy-fourth Session, Supplement No. 17 (A/74/17)*, annex II.

solutions and the relief that might be needed to support their development. That Model Law and its accompanying Guide to Enactment provide information that will prove useful to the directors and other office holders that are the focus of this section.

Glossary

4. This section uses the same terminology as other parts of the *Guide*. The following additional terms relate specifically to this section and should be read in conjunction with the terms and explanations included in the glossary contained in the Introduction to the *Guide* as well as the glossary contained in the Introduction to part three of the *Guide*:

(a) “Enterprise group member” means an enterprise that forms part of an enterprise group;

(b) “Group representative” means a person or body, including one appointed on an interim basis, authorized to act as a representative of a planning proceeding;

(c) “Group insolvency solution” means a proposal or set of proposals developed in a planning proceeding for the reorganization, sale or liquidation of some or all of the assets and operations of one or more enterprise group members, with the goal of protecting, preserving, realizing or enhancing the overall combined value of those enterprise group members;

(d) “Main proceeding” means an insolvency proceeding taking place in the State where the enterprise group member debtor has the centre of its main interests; and

(e) “Planning proceeding” means a main proceeding commenced in respect of an enterprise group member provided:

- (i) One or more other enterprise group members are participating in that main proceeding for the purpose of developing and implementing a group insolvency solution;
- (ii) The enterprise group member subject to the main proceeding is likely to be a necessary and integral participant in that group insolvency solution; and
- (iii) A group representative has been appointed;

Subject to the requirements of subparagraphs (i) to (iii) above, the court may recognize as a planning proceeding a proceeding that has been approved by a court with jurisdiction over a main proceeding of an enterprise group member for the purpose of developing a group insolvency solution within the meaning of the UNCITRAL Model Law on Enterprise Group Insolvency.

I. Background

1. Section one 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 impose obligations on directors in the period approaching insolvency, the relative advantages and disadvantages of such regimes remain the subject of debate.¹⁶ Section one underlines the need for taking early action when businesses face financial difficulty in order to avoid rapid decline and to facilitate rescue and reorganization. It also notes that, while many countries have refocused their insolvency laws to increase the options for taking early actions, little attention has been paid to creating appropriate incentives for directors to use those options.¹⁷ Section one encourages the development of appropriate incentives by identifying 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.

2. 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. Part three of the *Guide*, which addresses the treatment of enterprise groups in insolvency, 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 enterprise group members and may involve different levels of ownership and control. Those factors, together with adherence to the separate entity approach and the widespread lack of any explicit acknowledgement of the enterprise group reality in the legislation applicable to individual enterprise group members, raise a number of issues for directors of enterprise group members. Adherence to the separate entity approach typically requires directors to promote the success and pursue the interests of the company they

¹⁶ See section one, chap. I, paras. 8-10.

¹⁷ *Ibid.*, para. 6.

direct, respecting its limited liability and ensuring that its interests are not sacrificed to those of the enterprise group. That is to be achieved irrespective of the interests of the enterprise group as a whole, the position of the director's company in the enterprise group structure, the degree of independence or integration among enterprise group members and the incidence of ownership and control. However, where that company's business is part of an enterprise group and reliant, at least to some extent, on other enterprise 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. Failing to understand the complexity of the director's obligations may bring about the failure that is hoped to be avoided. Part three discusses in some detail the 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 enterprise group members or of the enterprise group more widely.¹⁸

4. The requirement to act in the interests of the directed company may be further complicated in the enterprise group context when a director of one enterprise group member performs that function or holds a managerial or executive position in one or more other enterprise group members. In such a situation, it may be difficult for the director to separately identify the interests of each of those enterprise group members and treat them in isolation. Moreover, the interests of those enterprise group members may be affected by the possibly competing economic goals or needs of other enterprise group members and those of the enterprise group collectively. The short and long-term implications for the interests of the different enterprise 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 enterprise 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 to protect the interests of creditors of the affected enterprise group members and other stakeholders.

5. Examples of situations in which the interests of individual enterprise group members may be affected by those of the enterprise group more widely may include: where one enterprise group member is a key supplier, provides finance to another enterprise group member, or acts as a guarantor for finance provided by an external lender to another enterprise group member, in an attempt to keep the enterprise group as a whole afloat, including its own business; where one enterprise group member agrees to transfer its business or assets or surrender a

¹⁸ See part three, chap. I.

business opportunity to another enterprise 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 the enterprise group member agreeing to such transfer, surrender or contract; or where an enterprise group member enters into cross-guarantees with other enterprise group members to assist the enterprise group as a whole to use its assets more effectively in financing enterprise group operations.

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

7. In determining the best interests of the directed enterprise group member, a director may weigh and consider various interests. These interests may also include the interests of other enterprise group members, or the enterprise group as a whole, where those interests are also consistent with the interests of the directed enterprise group member. To the extent that the course of action a director chooses to follow in such circumstances is reasonable and aimed at avoiding insolvency or minimizing its impact on the directed enterprise group member, that director should not be liable for breach of their obligations. Where having weighed the competing interests of the directed enterprise group members, the course of action chosen gives rise to a conflict between the obligations the director owed to those different enterprise group members, that conflict should be disclosed to the affected enterprise group members. Resolving such a conflict might require mediation or negotiation of the opposing interests.

8. 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 enterprise group member or members, some jurisdictions may permit directors to have regard, for example, to the direct or derivative commercial benefits accruing to that enterprise group member from pursuing a particular course of action with other enterprise group members and to the extent to which their enterprise group member's prosperity or continued existence depends on the well-being of the enterprise 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 enterprise group member as a result of the course of action taken and to consider the position of their enterprise 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 granted for a loan to another enterprise group member, especially where the survival of that other enterprise group member is not critical to the solvency of the enterprise group member giving the guarantee or security.

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

10. This section identifies the extent to which a director of an enterprise group member may take account of considerations beyond the enterprise group member managed by that director 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 members 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. While recognizing the desirability of achieving the goals of insolvency law (outlined in part one, chap. I, paras. 1–14 and recommendation 1) through early action and appropriate behaviour by directors, it is also acknowledged that there are threats and pitfalls for entrepreneurs that may result from overly draconian rules.

11. This section does not deal with the liability of directors under criminal law, company law or tort law. It focuses 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 members in the period approaching insolvency

A. The nature of the obligations

1. The underlying rationale of imposing obligations on directors in the proximity of insolvency is addressed in section one (chap. I, paras. 1-7), and remains equally applicable in the enterprise group context. The obligations of directors of an enterprise group member continue to be the same basic obligations as established in recommendation 255, but it might be desirable for the law 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) and the possibility of maximizing value in the enterprise group by designing a group insolvency solution to the enterprise group's financial difficulties that includes the whole enterprise group or some of its parts. Group insolvency solutions may require a director of an enterprise group member in financial difficulty to take steps that may appear, at first glance, to be detrimental to that enterprise 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 enterprise group member in financial difficulty may expose directors to liability for failure to discharge their obligations reasonably.

2. One consideration for directors evaluating the steps to be taken to address the enterprise group member's financial difficulties is the impact of those steps on creditors of that enterprise 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 enterprise 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.

3. Section one (chap. II, para. 5) discusses the types of steps that a director might reasonably be expected to take in order to address financial difficulty, to avoid the onset of insolvency and, where it is unavoidable, to minimize its impact. Those steps would continue to be relevant in the enterprise 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 enterprise group members. Those additional steps might be affected by the position of the enterprise group member in the enterprise group and require consideration of whether more value might be preserved or created by assisting the implementation of a group insolvency solution for the enterprise group as a whole or some of its parts, than by taking steps that relate only to the individual enterprise group member. Consideration might be given to assessing: the directed member's obligations, both financial and legal, to other enterprise group members; the transactions that should (or should not) be entered into with other enterprise group members; possible sources and availability of finance (both in the period approaching insolvency and once formal proceedings commence), including its provision by the directed enterprise group member to other enterprise group members; and the impact of possible group insolvency solutions, whether limited to the directed enterprise group member or involving the enterprise group more widely, on creditors and other stakeholders of the directed enterprise group member. A director might also consider taking steps to organize informal negotiations with creditors, such as voluntary restructuring negotiations, with a view to devising a group insolvency solution for the enterprise group as a whole or some of its parts where that will benefit the directed enterprise group member.

4. 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 enterprise group members and procedurally coordinating those proceedings, as discussed in part three of the *Guide* (recommendations 202-210).

Recommendations 267–268

Purpose of legislative provisions

The purpose of 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 enterprise 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 enterprise group member, including in situations where they are also responsible for making decisions concerning the management of other enterprise group members; and

(d) To permit an enterprise group member to be managed, where appropriate, in a manner that will maximize value of the enterprise group by promoting approaches to resolve insolvency for the enterprise group as a whole or for some of its parts, while taking reasonable steps to ensure that the creditors of that enterprise group member and its other stakeholders are no worse off than if that enterprise 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 a group insolvency solution for the enterprise group as a whole or some of its parts; the position of the enterprise group member in the enterprise group; and the degree of integration between enterprise group members;

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

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

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 person specified in accordance with recommendation 258 with respect to a company that is a member of an enterprise group;

(b) Insofar as not inconsistent with those obligations, the person referred to in subparagraph (a) may take reasonable steps to promote a group insolvency solution that addresses the insolvency of the enterprise group as a whole or some of its parts. In so doing, the person may take into account the possible benefits of maximizing the value of the enterprise group as a whole, while taking reasonable steps to ensure that the creditors of the enterprise group member and its other stakeholders are no

Recommendations 267–268 (continued)

worse off than if that enterprise group member had not been managed so as to promote such a group insolvency solution.

Reasonable steps for the purposes of recommendation 267

268. For the purposes of recommendations 255 and 267, and to the extent not inconsistent with the obligations of the person referred to in recommendation 267, subparagraph (a) to the enterprise group member to which that person was appointed, reasonable steps in the enterprise group context might include, in addition to the steps outlined in recommendation 256:

1. (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 group insolvency solution for the enterprise group as a whole or some of its parts;

(b) Considering the financial and other obligations of the enterprise 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;

(c) Evaluating whether the enterprise group member's creditors and other stakeholders would be better off under a group insolvency solution for the enterprise group as a whole or some of its parts;

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

(e) Holding and participating in informal negotiations with creditors, such as voluntary restructuring negotiations,¹⁹ where organized for the enterprise group as a whole or some of its parts; and

(f) Considering whether formal insolvency proceedings should be commenced.

2. Where formal insolvency proceedings are to be commenced, considering the court in which they should be commenced, whether a joint application²⁰ with other relevant enterprise group members is possible or appropriate and whether proceedings should be procedurally coordinated.²¹

¹⁹ See part one, chap. II, paras. 2-18.

²⁰ See recommendations 199-201.

²¹ See recommendations 202-210.

B. Identifying the persons who owe the obligations

5. 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 enterprise 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 an enterprise group member to take appropriate steps to address the financial difficulties of the directed enterprise group member or involve that member in the financial difficulties of other enterprise group members, to the detriment of the creditors of the directed enterprise group member. This may occur in numerous circumstances, such as: where the boards of the two enterprise group members consist of substantially the same persons; where the majority of the board of one enterprise group member is nominated by the other enterprise group member, which is in a position of control; where one enterprise group member controls the management and financial decision-making of the enterprise group; or where one enterprise group member interferes in a sustained and pervasive manner in the management of another enterprise group member, typically in the situation of a parent and controlled enterprise group member.

6. There may also be enterprise groups in which it is difficult to identify the precise boundaries between enterprise group members because management responsibilities across different boards are blurred. In addition, relevant executives and decision makers may be employed by enterprise group members several steps remote from the enterprise group member in question, and the separate identity and liability of that enterprise group member may be generally disregarded in the daily business of the enterprise 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 enterprise group member in question and to the enterprise group member by which they are employed.

7. Persons that might be considered to be a director in the enterprise group context could include another enterprise group member or the director of another enterprise group member, including a shadow director²² of that other enterprise group member. While some laws do not permit an enterprise group member to be formally appointed as a director of another enterprise group member, such an enterprise group member might nevertheless be regarded as a shadow director of that other member when it exercises influence over or directs its activities.

8. Section one (chap. II, paras. 13-16) discusses the persons who owe the obligations discussed above. Recommendation 258 adopts a broad formulation,

²² The term is explained in section one, chap. II, para. 13.

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 to that recommendation 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 section.

C. Conflict of obligations

9. 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 enterprise group member, whether as a result of the ownership and control structure of the enterprise group, the alliances between enterprise group members, family ties across the enterprise group or some other aspect of the manner in which the business or businesses of the enterprise group are organized.²³ Whatever the reason, a director who sits on the boards of, or has managerial responsibility for, a number of different enterprise group members may face, in the period approaching insolvency, a potential conflict between the obligations owed to those different enterprise 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 enterprise group member. The nature and complexity of the conflict may relate to the position of the directed enterprise group members in the enterprise group hierarchy, the related degree of integration between enterprise group members, and the incidence of control and ownership. Where a director sits on the boards of the parent and controlled enterprise 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 enterprise group member.

10. In addition, the interests of the directed enterprise group members may be closely intertwined with the enterprise group more widely, requiring the economic reality of the enterprise 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 enterprise group more widely and it may be appropriate for that subsidiary to provide funding in the short term for other enterprise group members in order to keep that wider business operating and ultimately save the business of the subsidiary itself.

²³ See part three, chap. I, paras. 6-15.

11. 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 enterprise 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.

12. 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, 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 enterprise 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 enterprise group member or members without the expertise necessary to address their financial difficulties. As noted in section one (chap. II, para. 27), resignation from the board will not render directors 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.

13. Good corporate governance that supports analysis of the situations of the respective enterprise group member 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 enterprise 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 enterprise group members can also lead to conflicting solutions and outcomes, which need to be carefully reviewed and assessed by directors.

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 enterprise group member. That situation may give rise, in the period approaching insolvency, to a conflict between the obligations owed to the different enterprise 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, from the point of time referred to in recommendation 257, a director of an enterprise group member who holds that position or a management or executive position in one or more other enterprise group members has a conflict between the obligations owed in relation to the creditors and other stakeholders of those different enterprise group members.

Reasonable steps to manage a conflict of obligations

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

(a) Obtaining advice to establish the nature and extent of the different obligations;

(b) Identifying the persons to whom the conflict of obligations must be disclosed and disclosing relevant information, including, in particular, the nature and extent of the conflict;

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

(d) Seeking the appointment of an additional director when the conflict of 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.

Annex V

Decisions of the United Nations Commission on International Trade Law, adopted on 18 July 2013 and 15 July 2019, and General Assembly resolution 68/107 B

A. Decisions of the Commission

1. At its 973rd meeting, on 18 July 2013, the Commission adopted the following decision:

The United Nations Commission on International Trade Law,

Recognizing that effective insolvency regimes are increasingly seen as a means of encouraging economic development and investment, as well as fostering entrepreneurial activity and preserving employment,

Considering that effective insolvency regimes, in addition to providing a predictable legal process for addressing the financial difficulties of troubled enterprises and the necessary framework for their efficient reorganization or orderly liquidation, should also permit an examination to be made of the circumstances giving rise to insolvency, and in particular the conduct of directors of such an enterprise in the period before insolvency proceedings commence,

Noting that the UNCITRAL Legislative Guide on Insolvency Law,¹ while addressing the obligations of directors of an enterprise once insolvency proceedings commence, does not address the conduct of directors in the period approaching insolvency and the obligations that might be applicable to directors in that period,

¹ United Nations publication, Sales No. E.05.V.10.

Considering that providing incentives for directors to take timely action to address the effects of financial distress experienced by an enterprise may be key to its successful reorganization or liquidation and that such incentives should be part of an effective insolvency regime,

Appreciating the support and participation of international intergovernmental and non-governmental organizations active in the field of insolvency law reform in the development of an additional part of the Legislative Guide addressing the obligations of directors in the period approaching insolvency,

Expressing its appreciation to Working Group V (Insolvency Law) for its work in developing part four of the Legislative Guide, on the obligations of directors in the period approaching insolvency,

1. *Adopts* part four of the UNCITRAL Legislative Guide on Insolvency Law, consisting of the text in document A/CN.9/WG.V/WP.113 as revised by the Working Group at its forty-third session (see A/CN.9/766) and by the Commission at its current session (see the report of the Commission on its forty-sixth session (A/68/17), para. 202), and authorizes the Secretariat to edit and finalize the text of part four of the UNCITRAL Legislative Guide on Insolvency Law in the light of those revisions;

2. *Requests* the Secretary-General to publish, including electronically, the text of part four of the UNCITRAL Legislative Guide on Insolvency Law, to transmit it to Governments and other interested bodies and to consider consolidating parts one to four of the Legislative Guide and publishing them, including electronically, at a future date;

3. *Recommends* that all States utilize the UNCITRAL Legislative Guide on Insolvency Law to assess the economic efficiency of their insolvency law regimes and give favourable consideration to the Legislative Guide when revising or adopting legislation relevant to insolvency, and invites States that have used the Guide to advise the Commission accordingly.

2. At its 1099th meeting, on 15 July 2019, the Commission adopted the following decision:

The United Nations Commission on International Trade Law,

Recalling General Assembly resolution 2205 (XXI) of 17 December 1966, by which the Assembly established the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade in the interests of all peoples, in particular those of developing countries,

Recognizing that effective insolvency regimes are increasingly seen as a means of encouraging economic development and investment, as well as of fostering entrepreneurial activity and preserving employment,

Considering that effective insolvency regimes should provide a predictable legal process for addressing the financial difficulties of troubled enterprises and the necessary framework for their efficient reorganization or orderly liquidation, and should also permit an examination of the circumstances giving rise to insolvency, in particular the conduct of directors of such enterprises in the period approaching insolvency,

Recalling the adoption of part four of the UNCITRAL Legislative Guide on Insolvency Law (2013),¹ which deals with obligations of directors of an individual company in the period approaching insolvency,

Noting the significance of enterprise groups, whether formed domestically or internationally, to international trade and commerce in an increasingly globalized world economy,

Recalling the adoption of part three of the Legislative Guide on Insolvency Law (2010),² which deals with the treatment of enterprise groups in insolvency, and the UNCITRAL Model Law on Enterprise Group Insolvency (2019),³

Recalling also that the work on the obligations of directors of enterprise group companies in the period approaching insolvency proceeded in Working Group V (Insolvency Law) in parallel with work on a draft model law on enterprise group insolvency, recognizing that neither part three nor part four of the Legislative Guide on Insolvency Law addressed the situation in which a director is appointed to, or holds a managerial or executive position in, more than one enterprise group member and a conflict arises in discharging the obligations owed to the different members,

Expressing its appreciation to Working Group V for its work in preparing an additional section of part four of the Legislative Guide on Insolvency Law that addresses the obligations of directors of enterprise group companies in the period approaching insolvency, with a focus on discharging the obligations of a director owed to the different enterprise group members,

Appreciating the participation in that work of international intergovernmental and non-governmental organizations active in the field of insolvency law reform,

¹ Official Records of the General Assembly, Sixty-eighth Session, Supplement No. 17 (A/68/17), para. 204.

² Ibid., Sixty-fifth Session, Supplement No. 17 (A/65/17), para. 233.

³ Ibid., Seventy-fourth Session, Supplement No. 17 (A/74/17), para. 110 and annex II.

Convinced that a legal framework that addresses a conflict of obligations in relation to the creditors and other stakeholders of different enterprise group members, with due regard to other considerations, in particular business recovery, should be part of an effective insolvency regime,

1. *Adopts* an additional section of part four of the United Nations Commission on International Trade Law Legislative Guide on Insolvency Law addressing the obligations of directors of enterprise group companies in the period approaching insolvency, as contained in document A/CN.9/990;

2. *Requests* the Secretary-General to publish, including electronically, in the six official languages of the United Nations, part four of the Legislative Guide on Insolvency Law, incorporating an additional section on the obligations of directors of enterprise group companies in the period approaching insolvency, and to disseminate it broadly to Governments and other interested bodies;

3. *Recommends* that all States utilize the Legislative Guide on Insolvency Law to assess the economic efficiency of their insolvency law regimes and give favourable consideration to the Legislative Guide when revising or adopting legislation relevant to insolvency, and invites States that have used the Legislative Guide to advise the Commission accordingly.

B. General Assembly resolution 68/107 B

On 16 December 2013, the General Assembly adopted the following resolution:

Part four of the Legislative Guide on Insolvency Law

The General Assembly,

Recalling its resolution 2205 (XXI) of 17 December 1966, by which it established the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

Recalling also its resolutions 59/40 of 2 December 2004, in which it recommended the use of the *Legislative Guide on Insolvency Law* of the United Nations Commission on International Trade Law,¹ and 65/24 of 6 December 2010, in

¹ United Nations publication, Sales No. E.05.V.10.

which it recommended the use of part three of the *Guide*, on the treatment of enterprise groups in insolvency,

Considering that effective insolvency regimes, in addition to providing a predictable legal process for addressing the financial difficulties of troubled enterprises and the necessary framework for their efficient reorganization or orderly liquidation, should also permit an examination to be made of the circumstances giving rise to insolvency and, in particular, of the conduct of directors of such an enterprise in the period before insolvency proceedings commence,

Noting that the *Legislative Guide*, while addressing the obligations of directors of an enterprise once insolvency proceedings commence, does not address the conduct of directors in the period approaching insolvency and the obligations that might be applicable to directors in that period,

Considering that the provision of incentives for directors to take timely action to address the effects of financial distress experienced by an enterprise may be key to its successful reorganization or liquidation and that such incentives should be part of an effective insolvency regime,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for developing and adopting part four of the *Legislative Guide on Insolvency Law*, addressing the obligations of directors of an enterprise in the period approaching the insolvency of that enterprise;²

2. *Requests* the Secretary-General to publish, including electronically, the text of part four of the *Legislative Guide* and to transmit it to Governments and other interested bodies;

3. *Recommends* that all States utilize the *Legislative Guide* to assess the economic efficiency of their insolvency law regimes and give favourable consideration to the *Guide* when revising or adopting legislation relevant to insolvency, and invites States that have used the *Guide* to advise the Commission accordingly.

² Official Records of the General Assembly, Sixty-eighth Session, Supplement No. 17 (A/68/17), chap. V, sect. B.

Further information may be obtained from:

UNCITRAL secretariat, Vienna International Centre
P.O. Box 500, 1400 Vienna, Austria

Telephone: (+43-1) 26060-4060
Internet: uncitral.un.org

Telefax: (+43-1) 26060-5813
E-mail: uncitral@un.org

