INSOL INTERNATIONAL

DIRECTORS IN THE TWILIGHT ZONE II

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International Association of Restructuring, Insolvency & Bankruptcy Professionals

Directors in the Twilight Zone II

Copies of this report are available from:

INSOL International
2-3 Philpot Lane, London, EC3M 8AQ, UK
Tel: +44 (0)20 7929 6679 Fax: +44 (0)20 7929 6678

Email: heather@insol.ision.co.uk
www.insol.org

Price £100.00 plus post & package

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I am very pleased to introduce the second edition of *Directors in the Twilight Zone*, which addresses the risks run by directors, managers and other third parties while operating companies in that twilight zone of insolvency. The first edition, which was produced in 2001, covered thirteen different jurisdictions and was extremely well received. In the second edition, we have been able to increase our coverage to nineteen jurisdictions.

The concept of limiting liability for a company's financial failure to the company's assets, and the clear distinction between the assets of the company and those of its proprietors, is one of the central tenets of economic development. It is essential that this protection extend not only to the owners, but also to the managers and officers of the company. Of course, if this protection was limitless, it would encourage irresponsible business or economic activity. Most jurisdictions, therefore, seek to limit the protection afforded to managers, directors and other third parties to situations not involving dereliction in the performance of their duties. Although the effectiveness of these efforts has varied widely, at no time is the need for effective corporate stewardship greater than in the period immediately prior to the corporate collapse – that Twilight Zone of Insolvency.

The team that produced this work, led by Gordon Stewart of Allen & Overy LLP, London is to be congratulated on completing this important work in a form that is both useable and useful.

I would also like to thank the trustees of the Barbican Settlement, Artemis Trustees Limited for their continued support of this publication and the Group of Thirty-Six.

The issue of effective corporate stewardship is enormously important to many emerging and developing economies, and we sincerely hope that this publication will assist those responsible for the development of their economic and regulatory systems.

Robert S. Hertzberg
President
INSOL International

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Foreword & Acknowledgement

Gordon Stewart, Allen & Overy, LLP

One of INSOL's unique abilities is bringing together professionals from across the world to network and to learn from each other. It occurred to me that one way of utilising this capability would be to produce a global comparative study of a particular area of practical difficulty to practitioners dealing with financially distressed companies. This was the genesis of the Twilight Zone project.

As to which particular area would be suitable for comparative study, I had often been struck by the different approaches across the world to what directors can or cannot do safely in that difficult period (what I dub the Twilight Zone) when a company runs into financial difficulty and it is not certain whether or not a formal insolvency will ensue or whether some form of consensual solution can be achieved among the stakeholders (the company, the debt and the equity). I had come across jurisdictions which had laws that threatened creditors by preventing them proving in a subsequent insolvency for credit afforded to an insolvent company. Some jurisdictions had strict criminal sanctions for directors. Other, more litigious cultures, which one might have expected to have a plethora of causes of action against directors, seemed in practice to have none. Finally there were the jurisdictions which seemed to focus on the reasonableness of the directors' conduct – a negligence test if you like. This fascinating disparity is the subject of this book, now in its second edition.

The first edition of the book covered jurisdictions from across the continents. For the second edition we have added eight countries and updated the contributions to the first edition. Many INSOL members have generously given of their time and expertise in writing about their jurisdictions (please see the table below this forward). Just as the second edition has built on the foundations of the first, we would hope in time to produce a third edition covering even more countries and we will be looking for new contributors in due course.

Our aim in producing the Twilight Zone has never been to write a legal treatise on directors' duties in the chosen jurisdictions. Further, the factual situation of any company will have a huge impact on the advice professionals give to its directors. So, the structure is a series of questions focussing on the key difficult areas for directors, creditors and other stakeholders – such as potential liabilities for insolvent trading, clawbacks, ability to borrow/provide new credit (and get security for that new credit) with answers to these questions for each jurisdiction. The vision is of the INSOL member rushing to catch a flight to an unfamiliar jurisdiction, grabbing the book and using the question and answer system to orientate him or herself in respect of the regime they are about to encounter so that they know in general terms the pressures (if any) being felt by the various players in the drama. We hope INSOL members find it useful.

Some major expressions of gratitude are necessary. Thank you indeed to the contributors of the material whose names are given in the table below – without their hard work and dedication we would literally have had no work product. Thank you to Neil Cooper, past President of INSOL, for his work as co-editor and also for his personal support for the project at all stages.

Finally, I would like to record my debt of gratitude to my colleague Helen Pattinson who updated the English version and shouldered the main burden of editing and organisation. Each contributor has stated his/her view of the position in his or her jurisdiction as at the summer (Northern hemisphere!) of 2004.

Gordon Stewart
Allen & Overy LLP, London

CONTRIBUTORS

Country	*Contributor*
Argentina:	Adolfo Rouillon World Bank Daniel Fernando Alonso Austral University – School of Business Sciences
Australia:	Peter Kemp Peter Kemp Solicitors Richard Fisher Blake Dawson Waldron Shane Roberts McInnes Wilson
Bermuda:	Jennifer Fraser John Riihiluoma Appleby Spurling Hunter
Brazil:	Thomas Felsberg Troy Petit Andrea Acerbi Felsberg, Pedretti, Mannrich Aidar Advogados e Consultores Legais
Canada:	Geoff Morawetz Goodmans LLP Angela Pollard Pollard & Associates Inc. Terry Dolan McCarthy Tetrault
China:	Prof. Xian-Chu Zhang, Faculty of Law, University of Hong Kong Prof & Dr. Shi Jing-xia, China University of International Business and Economics (UIBE)
Egypt:	Dr. M.I.M. Aboul-Enein, Director of the Cairo Regional Centre for International Commercial Arbitration
England:	Helen Pattinson Rob Westwater Jill Johnston and Gordon Stewart Allen & Overy LLP
France;	Tim Portwood Bredin Prat
Germany:	Dr. Bernd Meyer-Loewy Linklaters, Oppenhoff & Rädler

Country	*Contributor*
Hong Kong PRC:	David Kidd Marianne Hurley John Wacker Allen & Overy
India:	Sumant Batra Kesar Dass B & Associates
Italy:	Carlo Santoro Giuseppe Scassellati Sforzolini Cleary, Gottlieb, Steen & Hamilton Prof Luca Enriques University of Bologna
Japan:	Mr. Osamu Higuchi Keiwa Sogo Law Offices Mr Keiichi Sato The Tokyo Star Bank, Limited
Russia:	Sergei Dmitriev Clifford Chance CIS Limited
Spain:	Javier Gomez-Acebo Inaki Gabilondo Freshfields Bruckhaus Deringer
The Netherlands:	Eddy Meijer Houthoff Buruma Maurits Kalff De Brauw Blackstone Westbroek
New Zealand:	Mike Whale Lowndes Associates
United States of America:	Benjamin E. Marcus Jeffrey T. Piampiano Drummond Woodsum & MacMahon

DIRECTORS IN THE TWILIGHT ZONE

OVERVIEW

The world has come a long way since the notorious English case of *Re Cardiff Savings Bank*[1892] 2 Ch 100 where a director who was appointed to the board of the Cardiff Savings Bank at the age of six months and who attended only one board meeting in 38 years, was held not to be liable in negligence for mismanagement that had occurred.

The problem of officer liability for insolvency arises from the risks resulting from the separation of ownership and control. Directors manage other people's assets and so the law imposes duties on them to manage in the interests of the beneficiaries. As is so often the case, the real test of the credentials of a jurisdiction is on insolvency which is when legal doctrine really matters and when the law has to make a choice. Insolvency is a spoliator and destroyer and, since there is not enough to go round, the law has to choose between the victor and the victim. The shareholders have lost everything and the creditors have also lost much of their claims so it is not unnatural that those whose assets have been devastated in this way should look around for someone to blame. It is the task of the law to control these emotions in some common sense way which is proportional to the offence.

The main types of officer liability for insolvency are four in number as follows:

- **Fraudulent trading,** i.e. the intentional or reckless incurring of debts when the director knows that there is no prospect of paying, so that this is a fraud. The difficulties of proof make this liability unusual in the countries which have the rule, mainly because of the equivalents of the "silver-lining" or "sunshine" or "light at the end of the tunnel" tests exemplified in an English 1960 unreported case in which the court held that the directors were not liable if they genuinely believed "that the clouds will roll away and the sunshine of prosperity will shine on them": *Re White & Osmond (Parkstone) Ltd*

- **Negligent trading***,* i.e. incurring debts when objectively there is no reasonable prospect of paying them – a negligence standard on a balance of probabilities.

- **Compulsory stoppage on percentage loss of capital**, for example a duty to take appropriate action if there has been a 50% loss of capital. There may be a graduated response according to different levels of loss of capital.

- **Business misjudgements** leading to the insolvency e.g. borrowing beyond the capacity of the company to repay, committing the company to risky business ventures, inadequate budgeting, inadequate financial monitoring or supervision, inadequate insurance, unfunded capital investments, excessive dividends or imprudent investment in high risk securities or having too many employees.

The above areas of liability for causing the insolvency should be compared with other personal liabilities on directors for breach of company laws such as paying dividends out of capital, ultra vires transactions, misrepresentation in a prospectus or false or incorrect financial statements, self-interested transactions (such as personal loans by the company to the director or diversion of corporate opportunities to the director personally) and the like. Most jurisdictions impose civil or criminal liability or both for these violations of corporate law. One may also add personal liability for torts committed by the company and environmental pollution.

There is much overlap between these violations of company law and the personal liability for responsibility for the insolvency because the former company laws are often effectively intended to protect third parties against insolvency as that is when the delinquency often comes to light. Other examples of violations which are directly insolvency-related and which may give rise to personal liabilities include fraudulent transfers in breach of fraudulent preference rules and failures to account for taxes.

Pros and cons of personal liability of directors

The policies in favour of imposing personal liability for the insolvency include (1) early stoppage before it is too late with a view to protecting existing creditors from even greater losses and incoming creditors from getting embroiled, (2) controlling and disciplining management by the imposition of a tough sanction; and (3) an incentive on management to obtain competent professional advice when financial difficulties loom.

The disadvantages of the personal liability include (1) the possibility of a premature closure of the company and the shut down of viable businesses which could have survived; (2) the liability may inhibit the pursuit of workouts because directors are unwilling to trade out of difficulties – in this case the policy emphasis is on encouraging the use of judicial corporate rescue proceedings as self-protection to directors; (3) the liability erodes the veil of incorporation and weakens enterprise incentives: corporate enterprise is a powerful force for economic prosperity and productivity; too much risk may discourage directors; even if director and officer insurance can be paid for by the company, the cover is expensive and is often subject to wide exceptions; (4) the risk creates unpredictability by reason of the fact that the liability depends on particular circumstances and also the future attitudes of the courts; and (5) liability may increase the risk of unexpected liabilities for banks and others who are deemed to be de facto directors by reason of their involvement in the company, particularly at the time of the insolvency.

The personal liability of directors is essentially a feature of the "business judgment rule" which seeks to protect and promote the full and free exercise of the directors' managerial scope insulating their business decisions from judicial review and shielding directors from liability for those decisions, even if they subsequently turn out to be mistaken and lead to insolvency. At its most relaxed, all that is required from the business judgment rule is that the directors acted honestly with a view to what they thought were the best interests of the company and its creditors and with a fairly low standard of competence. In most countries the bar has now been raised but it is apparent that if a jurisdiction imposes liability for commercial mistakes, then almost invariably directors will be liable on insolvency since most insolvencies can be said to be attributable to some business misjudgement or supervision, as opposed to a cataclysmic external event which nobody could have foreseen or guarded against. The hindsight rule can take over – it is often easy to pinpoint the mistake after the event when it would not have been obvious in the usually hectic environment in which the decision was made. Also the court is invited to make the sort of commercial judgment which it is not appropriate for a court to make except in the case of obvious gross culpability.

Other issues

The incidence of the liability may depend in the first place on the type of company. In small or close companies, the directors will often be the same as the shareholders. In large companies, the management will usually be tiered between those who have overall management of policy and strategy (the board of directors, with or without a supervisory board, or non-executive directors) and those who have executive functions without being on the board, such as the executors, finance or marketing officers. In practice, the task of a board of a large company is to lay down matters of strategy, to approve large capital investments, budgets and financial commitments and to supervise executive management i.e. to see whether executive management is performing its functions and providing adequate information and reports. It is the task of the executives to implement the policy.

Where the management responsibilities are spread diffusely in this manner, there is an issue as to whether liability should be individual according to direct responsibility or whether the board stands or falls together under some theory of collective responsibility. It has often been held that a director is liable for failure to supervise an errant director where the supervision would have revealed a fraud or breach of duty by one delinquent officer.

Another issue is the extension of draconian powers of investigation by administrative tribunals and whether directors in these administrative proceedings receive a proper fair trial and the other protections available to normal defendants and those accused of criminal offences. Insolvency breeds such resentments that on occasion there is a marked lowering of the normal threshold.

International survey

An international survey is bound to be tentative and impressionistic. One may rank jurisdictions very broadly as follows:

> **High risk** Thus in France there is draconian personal liability of directors for serious business mistakes leading to the insolvency, e.g. risky ventures, imprudent borrowing, on failure to insure and often the bankruptcy of a major company has resulted in the near automatic bankruptcy of its directors. There are proposals in France to reduce this liability.
>
> **Medium risk** e.g. England, Ireland, Australia, New Zealand. Broadly, these countries adopt the principle of knowingly negligent liability for causing the insolvency. Thus, under Britain's Insolvency Act 1986, a director is personally liable if the company has gone into insolvent liquidation and the director "knew, or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation". The director has the deemed competence of a "reasonably diligent person" of his function e.g. finance director, and has a defence if he "took every step with a view to minimising the potential loss to the company's creditors that he ought to have taken" e.g. advice or a petition for an administration.
>
> **Low risk** e.g. United States. It seems that the personal liability of officers and directors for continued trading whilst insolvent is very rare in the US, apart from special legislation imposing tougher liabilities on directors of insured financial institutions. In Delaware for instance, the business judgment rule is protective of directors and there are no express statutory provisions imposing liabilities on directors for causing the insolvency on the lines of those found in Europe and

English-based jurisdictions. Nevertheless, in the United States, class actions against directors for causing loss to shareholders and creditors under plaintiff-oriented litigation rules are quite common (the actions are usually settled) and it has been argued that, as a result, the liability of directors in the US is not greatly different from that elsewhere. On the whole, however, it is suggested that the US is protective of directors and applies a carefully balanced business judgment rule.

Outside the above cases, one may note that the duty of directors to petition for insolvency proceedings or to notify the court or call a shareholders' meeting if one-third or one-half of the company's capital is lost is common in the Napoleonic and Roman Germanic jurisdictions, i.e. those outside the common law group and, indeed, Article 17 of the EU Second Company Law Directive imposes a duty on directors to call a meeting if more than one-half of the capital is lost: the UK does not prescribe civil liability for violation, but Belgium and Sweden (for example) do. It seems to be a near universal rule that the failure of directors to account for taxes, e.g. deductions from employee wages, attract personal liability: the moral is that directors should not borrow from the Revenue.

In the end, any comparative survey should be supported by detailed statistics in order to ensure that impressions are corrected by the realities. Comparative statistics of this type are not easy to compile and compare because of the number of variables which are involved and also the differing levels of practical enforcement of the black letter rules.

Conclusions

It is probably true to say that over recent years, there has been a marked toughening of the law as regards those assuming the mantle of a director, greater risks and an insistence on a more exacting attention to duties and responsibilities.

A further trend is the increased priority given to judicial rescue proceedings as opposed to out-of-court work-outs and, in turn, the imposition of liabilities on directors in order to encourage this process.

Apart from these big picture drifts or trends, there are enormous differences at the more micro level in the approach between jurisdictions and fundamental disagreements on the policies. The result is that when one gets to the all-important level of detail, there appears to be much fragmentation, fissuring and splintering of legal systems.

Philip Wood
Special Global Counsel, Allen & Overy LLP
Visiting Professor in International Financial Law, University of Oxford
Yorke Distinguished Fellow, University of Cambridge
Visiting Professor, Queen Mary College, University of London
Visiting Professor, London School of Economics & Political Science

ARGENTINA

QUESTION 1

1.0 The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 The "twilight" period is the time period which runs between the judicially decided date of commencement of insolvency and the judicial pronouncement of bankruptcy or liquidation proceedings (as defined by Argentina Bankruptcy Law 24.522, ABL 116). Under Argentinean insolvency law, the "twilight" period is not applicable to reorganisation proceedings. However, in the case of an indirect liquidation proceeding ("*quiebra indirecta*") which arises due to the frustration of a reorganisation proceeding, the "twilight" period is applied according to 1.5.2.

1.1.2 The following transactions may be vulnerable to attack under ABL 118 and 119 if entered into during the two years prior to: (a) the pronouncement of the bankruptcy or liquidation proceeding or (b) the filing by the debtor of a previously frustrated reorganisation proceeding ("*concurso preventivo"*) (ABL 116):

(a) gratuitous acts;

(b) the prepayment of debts not payable until the day of judicial pronouncement of bankruptcy or thereafter;

(c) security of any kind granted to secure an obligation not yet due;

(d) acts which cause damage to creditors, concluded during the "twilight" period where the other party is aware of the company's insolvency.

1.2 Does it depend on whether a formal insolvency procedure is instituted?

1.2.1 Transactions entered into during the "twilight" period are vulnerable to attack by creditors only when a formal insolvent liquidation - and not a reorganisation - procedure follows.

1.2.2 Further, personal liability on the part of directors or officers may not be raised by creditors unless a formal insolvent liquidation – and not a reorganisation – procedure follows. Although, the directors may be held liable for claims by individual creditors on the ground of damages suffered to his/her personal estate (Argentina's Corporation Law, 59).

1.2.. Shareholders may also challenge transactions entered into during the twilight period, and this can give rise to personal liability on the part of directors, irrespective of whether or not formal proceedings have been instituted.

1.3 Does it depend on the nature of the transaction?

1.3.1 The objective of insolvency is to ensure fair (traditionally expressed as "equal") treatment between all stakeholders. Accordingly, transactions concluded during the "twilight" period which are of the nature described in 1.1.2 (a) to (d). are vulnerable to attack by creditors.

1.3.2 Transactions referred to in 1.1.2 (a) to (c) above are automatically void against creditors - the instigation of legal proceedings by creditors or the sindico is not necessary. (ABL art. 118). Acts under 1.1.2 (d). require proceedings to be instigated by the sindico in order for a judicial decision to be reached declaring the act void vis-à-vis the creditors. The *sindico* must obtain previous authorisation by the simple majority (more than a half) of the admitted unsecured liabilities. A creditor may also pursue the same action at its own cost and risk, but only after petitioning the *sindico* to do so, and waiting thirty days for the *sindico* to act (ABL 120). Under cases in ABL 118, 119 and 120, the result is that the transaction is void vis-à-vis the creditors, but remains valid between the parties.

1.4 Does it depend on whether the party to the transaction is connected or associated with the company?

1.4.1 The length of the "twilight" period does not depend on whether the party to the transaction is connected or associated with the company.

1.4.2 Nevertheless, the relationship between the party to the transaction and the company is significant in determining whether the counter-party may be held personally liable. (Refer to 2.2.4 below for further information.)

1.5 Will any other circumstances lengthen or shorten the "twilight" period?

1.5.1 The "twilight" period is extended under two circumstances:

1.5.2 When the liquidation proceeding follows a frustrated reorganisation proceeding, the two year limit (ABL. 116) runs from the filing of the petition for the reorganisation proceeding.[1]

1.5.3 When considering the personal liability of directors or officers to creditors (ABL 173), the "twilight" period is extended back one further year prior to the date of the judicial pronouncement of insolvency (ABL 174), thus encompassing actions entered into by directors up to three years prior to the commencement of insolvency proceedings.

[1] Refer answer to 1.1.1.

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the “twilight” period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?

(iii) will liability attach to individual directors in proportion to their specific involvement?

(iv) is there a specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

2.1. General fiduciary duties

2.1.1 Directors are subject to certain general fiduciary duties imposed by statute. Argentina’s Corporation Law 19.550 (ACL) establishes that, in performing their functions, directors are required to act in good faith and with the diligence of a good businessman (“*buen hombre de negocios”*) (ACL 59).

2.1.2 ACL 59 is designed so that directors focus on the best interests of the company and its shareholders. However, the general fiduciary duty owed to the company and its shareholders becomes subject to an overriding duty to have regard to the interests of the company’s creditors in the event the company undertakes a reorganisation proceeding (ABL 15 to 17). In such cases, ABL provides for the debtor’s, and consequently its directors’ and officers’ duty to treat similarly situated pre-insolvency creditors in a similar fashion as regards their pre-insolvency claims. Such a duty may be seen as a consequence of the objective of insolvency to ensure fair treatment.[2]

2.2 Liability under Argentina’s Bankruptcy Law 24.452 (ABL)

2.2.1 Where a company is subject to reorganisation proceedings, failure to comply with the statutory provisions regarding the administration of the company and the treatment of creditors (ABL 15 and 16) may result in the separation of the debtor from the administration of the estate (ABL 17). Consequently, directors may be held liable for such actions. Statutory provisions provide a system of administration

[2] See 1.3.1

during reorganisation proceedings according to the following principles:

(a) freedom to enter into any transaction within the debtor's ordinary course of business[3] ("*administracion ordinaria de su giro comercial*"),

(b) requiring judicial authorisation prior to entering transactions that exceed the debtor's ordinary course of business (ABL 16, third paragraph),[4] and

(c) prohibition on performing gratuitous acts or acts affecting the pre-insolvency standing of creditors vis-à-vis other pre-insolvency creditors (ABL 16, first paragraph). Separation from administration of the estate does not impede the debtor's ability, and its directors and officers, to negotiate and eventually conclude a reorganisation agreement with its creditors.

2.2.2 A director or officer may be held personally liable if, during the "twilight" period (see 1.5.3) he deliberately produces, facilitates, permits or aggravates the deterioration of the estate of the company or its insolvency. Liability is to compensate for the damage caused by the director (ABL 173, first part). The action should be brought by the *síndico* (the judicially appointed trustee or insolvency administrator) within two years of the judicial pronouncement of the liquidation proceeding (ABL 174). Requirements for liability are:

(a) action by a person with capacity to represent the debtor[5],

(b) entering transactions which (1) produce, (2) facilitate, (3) permit, or (4) aggravate the company's economic or financial situation,

(c) performing the action deliberately (with "*dolo*"[6]), and

(d) damage to the company or its creditors[7].

2.2.3 A director or officer may also be held personally liable if, during the "twilight" period, or after the declaration of bankruptcy, he knowingly participates in acts directed to, and having the effect of diminishing the company´s assets or increasing its liabilities. (ABL 173, second part) Requirements for liability are:

(a) action by any person regardless of the person's capacity to represent the debtor[8],

(b) participating in actions tending to diminishing the debtor's assets or exaggerating its liabilities,

(c) performing the action deliberately (with "*dolo*"[9]), and

(d) damage to the company or its creditors[10].

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[3] Under Argentinian law, "ordinary course of business" is understood to mean activity ordinarily required to pursue the debtor's activity.

[4] A few examples are provided by the statute, which include: transactions involving any registered asset (movable or immovable), issuance of bonds with a floating charge or other security right, and granting pledges of mortgages on any of the debtor's assets (ABL 16, third paragraph).

[5] It is generally understood that members of a supervisory body are not liable through ABL 173, first part.

[6] Dolo is defined by art. 1072 of the Argentine Civil Code as requiring both knowledge and intention to produce damage.

[7] Benefit to the agent entering the action is not required.

[8] It is generally understood that the debtor's directors and officers as well as members of a supervisory body and any third party are liable through ABL 173, second part.

[9] Defined as in art. 1072 of the Argentine Civil Code. See previous footnote.

[10] Once more, benefit to the agent entering the action is not required.

The action should be brought by the *síndico* within two years of the judicial pronouncement of bankruptcy. (ABL 174) Liability extends to :

(a) the restitution of goods still under the director's power;

(b) the obligation to compensate for the damage caused; and,

(c). the loss of any right to claim against the insolvency estate. (ABL 173, second part), which includes the director's or officer's right as a creditor of the company.

2.2.4 ABL 161 refers to the extension of liquidation proceedings in cases of (a) a person acting on behalf of the company but in his own interests *known as "actuacion en interes personal*"- (ABL 161.1), (b) abuse of control committed by a controlling person – known as "*control indebido*"- (ABL 161.2) and (c) a person having its assets and liabilities confused with those of the debtor under liquidation proceedings – known as "*confusion patrimonial inescindible*"- (ABL 161.3).

2.2.4.1 Acting in the persons own interests is defined as: (1) any natural or legal person (2) appearing to act on behalf of the insolvent debtor (3) entering into transactions in his own interests and making dispositions of company's assets as if they were his own (4) in fraud to creditors (ABL 161.1).

2.2.4.2 Abuse of control is defined by ABL as the unlawful deviation of the controlled's interest, subjecting it to a unified direction in the controller's interest or in the group's interest (ABL 161.2)[11]. A controller[12] is defined as: (a) any natural or legal person who directly or through another person has such participation in the debtor company with the necessary voting rights to dictate social decisions (ABL 161.2.a); and (b) each of the – natural or legal- persons that acting jointly have the participation described above (ABL 161.2.b).

2.2.4.3 Having assets and liabilities confused with those of the debtor under liquidation proceedings results in the extension of liquidation proceedings to:

(1) any natural or legal person,

(2) whose assets and liabilities, or the majority of them cannot be clearly divided from those of the insolvent debtor (ABL 161.3).

2.2.4.4 The sanction for breach of these offences (2.2.4.1. to 2.2.4.3) is to extend the insolvency proceedings to include the controlling party's own bankruptcy. Though the provision does not mention the controller's directors as liable under it, directors and officers may be reached when:

(1) the definition of control is applicable to them, and

(2) they have abused such control. In such cases, the liquidation proceeding may be extended by the Court, regardless of his/her personal solvency. This is known as "*quiebra refleja*" (as a "reflex" of the original bankruptcy)

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[11] The mere existence of control is not punishable under Argentinian law. On the contrary, ABL art. 172 specifically provides that control by itself does not imply the application of ABL arts. 161 to 171. In addition, ACL also allows for the same interpretation.

[12] ACL art. 33 also defines control in its definition providing for both internal and external control. Definition of control by ABL 161.2 is considered to refer to internal control only. However, ABL 161.1 may be seen as encompassing cases of external control also.

and may be either an independent bankruptcy proceeding with a separate estate[13] or the formation of a single estate with assets from the original bankruptcy and the second bankruptcy[14].

2.3 Liability under Argentina's Corporation Law 19.550 (ACL)

2.3.1 ACL does not provide specific regulation about actions applicable to directors and officers in cases of insolvency. However, corporate actions, designed to be applied when the company is solvent, remain applicable during insolvency proceedings, regardless of whether such proceedings are reorganisations or liquidations. ACL establishes a number of actions for which a director may be found liable for corporate wrongdoing. These actions, set out below and described in ACL 276, 277 to 279, are actions based on liability, to which the general rules of the law of restitution apply. They may be brought regardless of the existence of insolvency proceedings. The general rule established by ACL art. 174 is that all directors will be held jointly and severally (*ilimitada y solidariamente*) liable to the corporation, shareholders, and third parties, for:

(a) any fraudulent or wrongful performance of their duties (ACL 59 y 274);

(b) any violation of the law, the company's articles of incorporation or by-laws; (ACL 274) and,

(c) any other damage caused deliberately or arising from an abuse of their position. (ACL 274)

Nevertheless, exceptions of personal liability by one or more directors may exist when there are personally assigned functions according to regulation by the company's articles of incorporation, by-laws or decision of the shareholders' meeting. In such cases, both the shareholders' decision and the assignment of personal functions must be registered at the Public Registry of Commerce ("Registro Publico de Comercio") (ACL 274, second part).

2.3.2 These actions can be summarised as follows:

(a) ACL 276, first part, describes the action which may be brought against one or more directors of the corporation. It presupposes a detriment to the company's estate and must be approved at a shareholder's meeting. The decision of the shareholders has the effect of automatically removing the director from his position and requiring the appointment of a substitute. This action is brought on behalf of the corporation and by the corporation itself against the directors; but any shareholder may promote it if the action is not commenced by the appropriate corporate body within three months of the shareholder's meeting (ACL 277). In a liquidation, the *síndico* may continue the action (ACL 278 and ABL 175) or it may be continued by any interested party, including the shareholders (ABL 176 *in fine*).

(b) ACL 276, second part, allows the above action to be brought by any shareholder who has objected to the approval of the directors' or officers' performance at the shareholders' meeting. Here again the action is brought on behalf of the corporation, but by a shareholder. As with the

[13] The system is called separate estates ("masas separadas") (ABL art. 168).
[14] The system is called unified estate ("masa unica") (ABL art. 167).

action in ACL 276, first part, in a liquidation, the *síndico* may continue the action (ACL 278 and ABL 175), or it may be continued by any interested party, including the shareholders (ABL 176 *in fine*).

(c) ACL 277 allows any shareholder, to file an action described in ACL 276, first part, where the corporation has failed to do so and three months have expired since the approval of the shareholders was obtained[15]. In this case, the shareholder acts in the place of the corporation.

(d) ACL 279 states that both the shareholders and third parties always have an individual right of action against directors. The damage for this action being personal to the plaintiff and not corporate[16]; consequently the action is brought by the shareholder or third party under its own interest and not on behalf of the corporation[17]. This right of action arises from any loss caused to the shareholder's estate[18] or to the third party and does not depend on any previous corporate proceeding or decision having been brought. This right of action is not, therefore, affected by any approval of the directors' duty at the shareholders' meeting.

(e) ACL 54 refers to the liability for damages to the company committed by a controlling person[19]. It does not mention the controller's directors as being liable. Nevertheless, liability may be founded on the general principle of torts, under Argentina's Civil Code art. 1109. There are two possibilities for actions under ACL 54. Requirements for ACL 54, first part to proceed are:

  (a) action by any controlling party,

  (b) which causes damage to the company, and (c) damage being the result of negligence or deliberation ("*dolo*"[20]). . Requirement for ACL 54, second part to proceed is the use by any controlling party of corporate funds or assets on the users or a third party's behalf. Restitution for this case implies restitution of the benefits obtained[21].

2.4 Liability under Argentina's Penal Code (APC)

2.4.1 The APC describes the criminal offences that may be committed by directors in the performance of their duties:

(a) APC 173, inc. 7: abusive, unfaithful, or fraudulent administration. Although this is not a specific provision aimed at corporate directors, since it applies to any person in charge of goods or economic interests other than his/her own, directors may be charged with this offence and punished with imprisonment. The offence is either to impair the confided interests or to abusively obligate their owner, and requires the violation of the administrator's duties with the intention of causing damage or obtaining an undue advantage for him/herself or a third party.

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15 See comment in 2.3.2.(a).
16 Thus different from actions from ACL 276 first and second parts. See 2.3.2.a. and 2.3.2.b.
17 Contrary to actions from ACL 276 first and second parts. See 2.3.2.a. and 2.3.2.b.
18 For damage to the shareholder's estate is usually understood damage to the value of shares.
19 This action is also applicable to damages caused to the company by its shareholders.
20 See footnote 7.
21 If there is loss, it is only suffered by the controlling party.

(b) APC 300, inc. 3: the publication, certification, or authorisation of false or incomplete corporate documents. The offence must have been committed deliberately and is punishable by imprisonment. The corporate documents to which this offence applies include balance sheets and Board minutes.

(c) APC 300, inc. 3: providing false information or failing to provide adequate information as to the company's financial situation. This offence must have been committed deliberately but regardless of the reason, and the false or inadequate information must have concerned important facts about the financial position of the corporation. It is punishable by imprisonment.

(d) APC 301: directors or officers´ deliberately consenting or participating in the performance of acts which are in violation of the law, articles of incorporation, and by-laws of the company, and which may cause damage. Punishable by imprisonment, the sanction is aggravated if the offence involves the issue of stock.

(e) APC 176/178: fraudulent bankruptcy and bankruptcy caused by criminal negligence. Punishable by imprisonment, the sanction applies to directors found guilty of co-operating or participating in acts of criminal negligence or fraud causing damage to the insolvent company's estate and/or to its creditors.

2.5 Penal liability under other laws

2.5.1 Various offences of a penal nature are described in specific statutes governing other areas of law, the most important being: tax violations in Penal Tax Law 24.769; environmental violations in Toxic Waste Law 24.051; social securities violations in Law 24.241; antitrust violations and violations to labour accident duties in Labour Risks Law 24.557.

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Liability under Argentina's Bankruptcy Law 24.452 (ABL)

3.1.1 The general rule[22] is that any person involved in the affairs of a company may be found liable, as if he were a director, under ABL 173, second part, for having knowingly participated in acts directed to and having the effect of diminishing the company's assets or increasing its liabilities (as set out in *2.2.3)*. Parties entering into contracts with the company, necessary participants and the like are considered included in this provision, as are members of the company's supervisory body.

3.1.2 A more specific case is provided for under ABL 173, first part. Any officer or person representing the corporation may be found liable, as if he were a director, under ABL 173, first part, for transactions entered into during the twilight period which deliberately produce, facilitate, permit or aggravate the deterioration of the estate of the company or its insolvency. (as set out in *2.2.2.*) To be included under this case, the person must have the capacity to represent the corporation or administer some or part of its assets. Officers and agents of the corporation are considered included under this case, while members of supervisory boards are considered excluded.

3.1.3 A creditor who, whilst aware of the corporation's insolvency during a reorganisation proceeding, has entered into a transaction in breach of the administration rules (ABL 15 to 17) is vulnerable to attack through actions of fraud, or simulation brought under civil law.

3.1.4 ABL 161 refers to the extension of liquidation proceedings to cases of:

(a) persons acting on behalf of the company but guided by their own interests (ABL 161.1)[23],

(b) abuse of control (ABL 161.2)[24], and

(c) a person having its assets and liabilities confused with those of the debtor under bankruptcy proceedings (ABL 161.3)[25]. Anybody who meets one of these criteria may suffer as sanction the extension of the insolvency proceedings. This is again known as "*quiebra refleja*"[26], which means the declaration of bankruptcy of the person involved with the company's affairs, regardless of the person's solvency.

3.1.5 ABL does not have a concept of de facto directors. However, persons acting in such circumstances could be reached by the application of the principles in 3.1.

3.2 Liability under Argentina's Corporation Law 19.550 (ACL)

3.2.1 ACL establishes a general rule about corporate officials with duties in the company's administration or with ability to represent the company. In the performance of their duties, they may be held liable on the same terms and to the same extent as directors, but without in any way limiting the liability of the directors themselves (ACL 270).

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22 For a more specific case of liability for person's involved in company's affairs, see 3.1.2.
23 See discussion in 2.2.4.1.
24 See discussion in 2.2.4.2.
25 See discussion in 2.2.4.3.

3.2.2 Accordingly, officers are liable to the corporation and third parties for:

(a) any fraudulent or wrongful performance of their duties (ACL 59 274);

(b) any violation of the law, the company's articles of association or by-laws; (ACL 274) and,

(c) any other damage caused deliberately or arising from an abuse of their position. (ACL 274)

3.2.3 The actions which may be brought against directors, as set out in *2.3.2,.* are also applicable to corporate officials under 3.2.1. (ABL 270).

3.2.4 ACL establishes a general rule about the liability of members of the Supervisory Board. The provisions in ACL 273, 274, 275, 276, 277, 278 and 279 are also applicable to them. Members of the supervisory board are shareholders elected by the shareholder's assembly (ACL 280) with specific duties in the supervision of the Board of Director's performance (ACL 281).

3.2.5 Companies can choose to have a private supervisor instead of the Supervisory Board. The supervisor will be liable for any breach of law or statutory duties. In addition, the supervisor may be held liable, together with directors, in circumstances where his/her conduct according to law or statute could have prevented the damage suffered by the corporation. (ACL 297) The role of the private supervisor is similar to that of the Supervisory Board (ACL 294).

3.3 Liability under Argentina's Penal Code (APC)

3.3.1 The conduct described in *2.4.1.* is applicable in certain limited circumstances to other persons involved in the affairs of the corporation.

3.3.2 APL 173, inc. 7, is, arguably, applicable to officers.

3.3.3 APL 300, first and second parts, are applicable to members of the Supervisory Board and liquidators and, arguably, to officers.

3.3.4 APL 301 is applicable to liquidators of the corporation and, arguably, to officers.

3.3.5 APL 176/178 is applicable to the directors, members of the Supervisory Board, managers (gerente de la sociedad o establecimiento) and the corporation's accountants.

QUESTION 4

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4. Counterparties dealing with the company during the "twilight" period

(a) From the point of view of a counterparty dealing with the company during the “twilight” period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

*4.*1 General rule

4.1.1 The general rule for transactions entered into by the company during the “twilight” period is that they may be vulnerable to attack, following commencement of liquidation proceedings (ABL 119).

4.1.2 A few transactions are automatically treated as void vis-à-vis creditors upon declaration by the insolvency judge. These transactions are:

(a) gratuitous acts;

(b) the early payment of debts which are not actually payable until the day of judicial pronouncement of bankruptcy or thereafter; and,

(c) granting security of any kind to secure an obligation not yet due (ABL 118).

4.2 Reviewable transactions

Any transaction may be subject to challenge under the general rule set out in 4.1.1, if it impairs creditors’ interests. Proceedings must be brought by the *síndico,* with the prior approval of the majority of the verified creditors. The insolvency judge’s decision is subject to appeal by the injured party.

Proceedings challenging a transaction on this basis may be brought by creditors of the company once formal insolvent liquidation proceedings have been commenced.

Proceedings can also be brought by the *sindico* to challenge specific transactions which will automatically be treated as void (i.e., not valid against creditors) upon a declaration of the insolvency judge. Proceedings to challenge the transaction need not be brought by a third party. Rights of appeal exist. A creditor who, during the twilight period, was aware of the corporation’s insolvency and entered into a transaction with the company, may not oppose the right of other creditors subsequently to challenge the transaction (See *1.1.2 (d))* The transaction will be challengeable if it caused damage to the creditors by deteriorating the insolvency estate. The onus of proving the absence of damage is on the creditor who entered into the transaction, knowing of the company’s insolvency. (ABL 119).

4.3 Defences

4.3.1 It will be a defence to any challenge brought on the basis of the general rule - that the interests of creditors have been impaired - to show that no damage to creditors has actually been caused (ABL 119).

4.3.2 There are no defences expressly provided for in the ABL for the transactions mentioned in 4.1.2, although clearly the transaction must fall within the terms of a 'gratuitous act', an 'early debt repayment' or the 'creation of a preference' in order for the transaction to be set aside.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

***5.*1 General rule**

5.1.1 In the case of a company against whom liquidation proceedings have been commenced, the authority and powers of the directors are taken over by the *síndico (the office holder appointed to the company)*. Consequently, in most cases, the power to bring actions against directors, officers, and others identified in *Question 3* lies in the hands of the *síndico*, who must obtain the authority of the majority of the creditors for that purpose.

5.1.2 A creditor can bring an action if the *síndico* fails to do so.

5.1.3 The main exception to these general rules is in relation to criminal proceedings for the offences detailed in *question 2*. Any person, or the Public Prosecutor, may bring proceedings for criminal offences.

5.2 Corporate proceedings

5.2.1 Actions against directors, officers and members of the supervisory board, based on ACL 276 and 277[27], may be brought by the *síndico*, though shareholders and third parties retain the right to claim for personal damage suffered by them. (ACL 279)[28]

5.2.2 ABL 175, second part, states that corporate actions commenced prior to the judicial pronouncement of insolvent liquidation proceedings may continue to be heard before the insolvency judge. In this event, the *síndico* must decide whether to continue the pre-existing proceedings or bring an action based on the Insolvency Law.

5.3 Bankruptcy proceedings

5.3.1 It is the *síndico* in liquidation proceedings who may bring proceedings in relation to: reviewable transactions (ABL 119), director's liability (ABL 173, first and second parts), corporate officials' liability (ABL 173, first and second parts), liability of members of the Supervisory Board ((ABL 173, second

27 See discussion in 2.3.1 and 2.3.2.
28 See discussion in 2.3.2.(d).

part), and others (ABL 173, second parts). The *síndico* must obtain the prior approval of the majority of creditors.

5.3.2 A creditor can bring the action if the *síndico* fails to do so (ABL 120) or if the *sindico* fails to obtain the required majority (ALB 119). The creditor does so at his own expense.

5.3.3 Actions based on Civil Law, for a declaration of fraud in relation to a particular transaction may only be commenced or continued by a creditor when the *síndico* has failed to act within thirty days of being required to do so by the creditor (ABL 120, second and third part).

5.3.4 Either the *síndico* or a creditor may bring an action to extend the ambit of the liquidation proceedings (ABL 163)[29] to:

(a) persons who have lead third parties/creditors to believe they were the insolvent debtor; (ABL 161, 1)

(b) any person who controls the insolvent debtor and who has guided its conduct towards interests other than those of the insolvent debtor; (ABL 161, 2)

(c) any person whose assets and liabilities (*patrimonio*) are so co-mingled with those of the insolvent debtor that determination of each person's assets and debts is impossible. (ABL 161, 3)

The application to extend the liquidation proceedings must be brought within the time limit set out by ABL 163.

QUESTION 6

6. Remedies: orders available to the domestic court

See response to question 2.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above)

[29] See discussion in 2.2.4.

obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Duty to cooperate

7.1.1 ABL 17, 102, 274 and 275 establish general rules of co-operation.

7.1.2 In liquidation proceedings, the directors, corporate officials and representatives of the insolvent company are obliged to co-operate with the *sindico* (office holder) and with the court, to provide information about the situation of the estate and/or the company's liabilities. The court has the power to enforce this duty to co-operate. Any person failing to fulfil her/his duty to attend before the court to provide information may be arrested (ABL, 274 inc. 1 and 275 inc. 3).

7.1.3 With reorganisation proceedings, any director who fails to provide the information required by the court and/or by the *sindico* (office holder) may be removed from office by the court.

7.2 Human Rights

7.2.1 Article 18 of the National Constitution establishes that "no one is obliged to self-incriminate him or herself". Accordingly, in insolvency proceedings this provision may be invoked as a ground for refusing to provide information that could be considered as self-incriminating. This provision would be applicable, for example, where information requested of a person involved in insolvency proceedings could potentially bring a criminal proceeding against him or her.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(See: answers to questions 1 and 2)

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

8.1.1 The limitation period for actions brought under Argentina's Bankruptcy Law intending to declare certain acts inopposable to creditors[30] is three years from the declaration of bankruptcy (ABL 124). Actions brought under ABL 173, first[31] and second part[32] have a limitation period of two years from the judicial pronouncement of liquidation/bankruptcy proceedings. Actions brought under ABL 161 have a limitation period equivalent to the time between declaration of bankruptcy and six months following the general report[33] by the sìndico (ABL 163).

8.1.2 The general rule is that no limitation period applies to criminal proceedings unless stipulated by statute.

8.2 Appeals

8.2.1 In civil and/or penal proceedings, an appeal is always available against the decision of a court of first instance. In insolvency proceedings, the rule is inappelability unless the statute explicitly indicates otherwise (ABL 273.3).

QUESTION 9

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9. Foreign corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations and companies?

*9.*1 General rule

The legal provisions outlined above apply to companies subject to liquidation proceedings in Argentina. In a liquidation context, provisions by ABL would apply. However, ACL provisions would remain applicable, though a company under liquidation proceedings in Argentina is bound to be wound up.

ACL 121 establishes that representatives of foreign companies have the same responsibilities and liabilities as directors and officers of domestic companies.

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[30] See discussion in 1.1. and 1.3.2.

[31] See discussion in 2.2.2.

[32] See discussion in 2.2.3.

[33] The general report by the síndico (ABL 39) includes, among other legally-required contents: a description of the causes leading to the debtor´s economic situation, inventory of its assets and an assessment of their value, account of the debtor´s liabilities, report on the accounting books kept by the debtor, the síndico´s opinion as

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 There is no insurance available to provide effective protection for directors against personal liability which may arise in connection with the liabilities discussed above.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.2 Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period?

Actions potentially giving rise to liability for directors are discussed under question 3, and for other persons involved in the company are discussed under question 4. Those discussions provide the overall system for directors and officers liability during the twilight period. Neither ACL nor ABL include specific provisions on financing obtained during this period, so accordingly the rules discussed above should apply.

An unconnected third party providing credit to a company during the twilight period should take ABL 119[34] into account. If the third party knows that the company is insolvent though not legally declared as such, the provision of credit may be rendered inopposable to creditors in a future liquidation proceeding.

34 See discussion in 4.

AUSTRALIA

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Background

1.1.1 Division 2 of Part 5.7B of the *Corporations Act* ("Voidable transactions") deals with those company transactions which are vulnerable to attack during the period preceding formal insolvency. The start and duration of the "twilight" period depends on the nature of the transaction and the identity of the parties to it.

1.1.2 A number of concepts central to Part 5.7B are described below.

(a) Insolvent transaction

A transaction is an insolvent transaction if it is either an unfair preference given by the company or an uncommercial transaction, and either the company was insolvent at the time or became insolvent because of the transaction (s. 588FC).[1]

(b) Unfair preference

A payment by the company will be an unfair preference if it results in a creditor receiving more than the creditor would have received in respect of an unsecured debt if that creditor were to prove for the debt in the winding up of the company (s. 588FA).

(c) Uncommercial transactions

A transaction will be deemed "uncommercial" where a reasonable person in the company's circumstances would not have entered into the transaction, having regard to the benefits and detriment to the company, and the benefits to other parties, of entering into the transaction (s.588FB).[2]

(d) Unfair loans

A loan to the company will be deemed "unfair" if the interest or charges were extortionate at the time the loan was made (s. 588FD).

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[1] All references are to the Australian Corporations Act. Note that other statutes in Australia also deal with the personal liability of directors (see, eg, s. 325 of the Co-Operatives Act 1992 (NSW); s. 188 of the Life Insurance Act 1995 (Cth); s. 52 of the Occupational Health and Safety Act 1985 (Vic)).

[2] An officer of the company may also contravene s. 596(b) by making a transfer or gift of company property with intent to defraud the company, shareholders or creditors.

(e) Relation-back day

The time period in which transactions are vulnerable to attack is determined by reference to the "relation-back day".[3]

In the majority of cases the relation-back day will be the day upon which the application for the winding up of the company is filed with the court.[4]

1.2 What time frames are involved?

1.2.1 Where a company is being wound up, past transactions may become voidable transactions pursuant to s. 588FE.

1.2.2 Section 588FE also provides the relevant time frames in which the transaction must have occurred in order for it to be voidable.

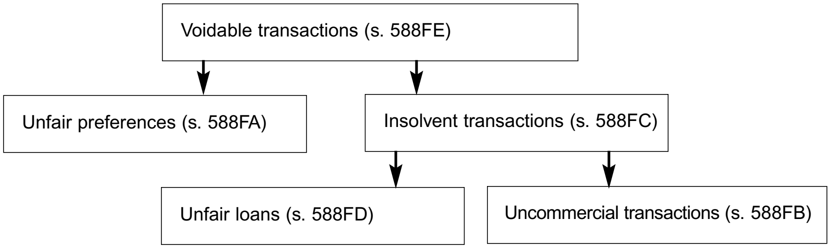
TYPE OF TRANSACTION	Length of time prior to relation-back day	Section
Insolvent transaction (with non-related entity)	6 months (or after the relation-back day but on or before the day when the winding up began)	588FE(2)
Insolvent *and* uncommercial transaction (with non-related entity)	2 years	588FE(3)
Insolvent transaction to which a related entity[5] of the company is a party	4 years	588FE(4)
Insolvent transaction entered into for the purpose of defeating, delaying, or interfering with, the rights of any or all of the company's creditors	10 years	588FE(5)
Unfair loan	No time limit until start of winding up (which may be after the relation-back day)	588FE(6)

3 Defined in s. 9.

4 If the company was in voluntary administration or subject to a deed of company arrangement when the winding up order was made, then the relation-back day will be determined by reference to the day on which the administration began (s. 513C).

5 The term "related entity" is defined in s. 9, and includes a promoter of the company, a director and a relative or de facto spouse of those persons.

1.2.3 The following diagram[6] illustrates the meaning of “voidable transaction” in the *Corporations Act.*



1.2.4 The following timeline summarises the start and duration of the “twilight” period and the length of time following formal insolvency proceedings during which creditors and others can take action against directors and company officers.[7]

No time limit until start of winding up	Unfair loan (s. 588FE(6))
10 years	Insolvent transaction to defeat creditors (s. 588FE(5))
4 years	Insolvent transaction with a related entity (s. 588FE(4))
2 years	Insolvent and uncommercial transaction (with non-related entity) (s. 588FE(3))
6 months prior to relation-back day until start of winding up	Insolvent transaction (with non-related entity) amounting to an unfair preference (s. 588FE(2))
	Relation-back day (see note in 1.2.5)
3 years after the relation-back day or within such longer period as the court orders on application by the liquidator within those 3 years (s. 588FF(3))	Proceedings brought in respect of voidable transactions pursuant to sections 588FE and 588FF
6 years from relation-back day	Actions against directors by the (Deputy) Commissioner of Taxation (s. 588FGA), actions against directors for compensation for insolvent trading (s. 588M), actions against persons (including directors) with respect to agreements or transactions entered into to avoid employee entitlements (s. 596AB), an action against a holding company for loss resulting from insolvent trading (sections 588V and 588W)

6 Layout suggested by Andrew Keay.

7 Note that this response to questionnaire does not deal with avoidance of dispositions of property made after the commencement of winding up by the court (s. 468).

1.2.5 Note: relation-back day is defined in s. 9 of the *Corporations Act.* If the company was in voluntary administration or subject to a deed of company arrangement when the winding up order was made, the relation-back day is determined by reference to the day on which the administration began (eg appointment of administrator): s. 513C. In other cases (eg where a creditor applies to the court to wind up the company), the relation-back day will be the day on which the application for the winding up of the company is filed with the court (s. 513A).

Floating charges

1.3.1 Any floating charge on the property of the company which was created in the six months ending on the relation-back day (or after that day but on or before the day when the winding up began) is (with some exceptions – see 11.2.3) void against the company's liquidator unless the company was solvent immediately after the charge was created (s. 588FJ).

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(vi) what defences, if any, will be available in relation to each offence?

2.1 Acts during the "twilight" period for which a director may be held personally liable or suffer other adverse consequences[8]

The following are the principal acts set out in the *Corporations Act* (there are others referred to in other legislation and the common law):[9]

[8] At common law directors may, in addition, owe duties to creditors where the company is insolvent: Walker v Wimborne (1976) 137 CLR 1 (but now see Spies v The Queen [2000] HCA 43 where the High Court indicated agreement with those commentators who doubt that the court in Walker v Wimborne was suggesting that directors owe an independent duty direct to creditors, rather than a mere restriction on the right of shareholders to ratify breaches of the duty owed to the company).

[9] Note that liability for acts (b)-(f) and (h) arises even if the act is performed outside the "twilight" period.

(a) failing to prevent the company from incurring a debt while insolvent ("insolvent trading"): s. 588G;[10]

(b) failing to exercise powers and discharge duties with care and diligence (s. 180);[11]

(c) not acting in good faith (s. 181);[12]

(d) misuse of position (s. 182);[13]

(e) misuse of company information (s. 183);[14]

(f) entering into an agreement or transaction to avoid or reduce employee entitlements (s. 596AB);[15]

(g) causing or allowing the company to make a payment of money to the Commissioner of Taxation that is later found to be a preference under s. 588FE (s. 588FGA); and

(h) falsification of books; false and misleading statements and information (sections 1307-1309).[16]

2.1.2 The Corporations Act (s197) provides that where a trust deed of which a company is trustee excludes the trustee's right of indemnification from the trust assets, the directors of the corporate trustee have personal liability for the debts incurred by it. That section has now been construed as imposing personal liability upon the directors of a corporate trustee for the debts it incurs in circumstances where, as a practical matter and by reason of an insufficiency of assets, those debts are not able to be paid; *Hanel v O'Neill* (2003) 48 ACSR 378. That liability is absolute

2.2 Liability for insolvent trading under s. 588G

(i) Liability of a director may be:

(A) **civil** (s. 588G(2) or s. 588M) which may also involve:

- a compensation order (s. 1317H); or
- a civil pecuniary penalty order[17] (s 1317G); or

[10] The director may also contravene s. 596(a) by fraudulently obtaining credit for the company. This is a criminal offence: s. 1311.
[11] Liability is imposed on directors and other officers.
[12] See above, n 11.
[13] Liability is imposed on directors, other officers and employees.
[14] See above, n 13.
[15] Liability is imposed on a "person", which includes a director.
[16] Liability is variously imposed on a "person" or an "officer", which includes a director. See also related offences in s. 590.
[17] Certain contraventions of the Corporations Act involve breaches of "civil penalty provisions" for which a compensation order (s. 1317H) and/or a civil penalty order (being payment of a fine to the Commonwealth of up to $200,000: s. 1317G) is imposed. Such breaches are provable according to the civil standard, that is, on the balance of probabilities. Other contraventions of the Corporations Act are classed as "offences" and are effectively criminal breaches in the strict sense. They carry penalties of imprisonment or financial penalty and are provable according to the criminal standard of proof - ie beyond reasonable doubt (eg s. 588G(3) - insolvent trading to a criminal degree; s. 184 - lack of good faith, misuse of position or information to a criminal degree). Certain offences and contraventions of civil penalty provisions may also give rise to disqualification from managing a company and therefore holding the position of director (see sections 203B and 206A-206F).

(B) **criminal** if dishonesty and suspicion of insolvency are involved (s. 588G(3)).[18]

There is to be no double recovery in actions for insolvent trading under s. 588M (s. 588N).[19]

Civil penalty proceedings are not to be taken, or are to be dismissed, if criminal proceedings resulted in a conviction: sections 1317M and 1317N. However, criminal proceedings may be taken after civil penalty proceedings regardless of outcome: s. 1317P.

(ii) Whether a director can be made personally liable in respect of the whole loss caused to the company or the deficit to creditors depends, in non-criminal proceedings, upon who makes the application for recovery.

(A) If the **liquidator** (under s. 588M(2)) or a **creditor** (under s. 588M(3)) applies, the liability of the director is limited to the loss or damage suffered by the creditor.

(B) If the **ASIC**[20] applies (under s. 1317J), the director may be liable for the loss or damage to the company (including profits made by anyone as a result of insolvent trading) pursuant to a compensation order, or may be liable to pay a fine to the Commonwealth of Australia pursuant to a pecuniary penalty order.

(C) If the **company**[21] applies (under s. 1317J), the director may be liable for the loss or damage to the company (including profits made by anyone as a result of insolvent trading) pursuant to a compensation order.

In criminal proceedings, the compensation that the court may require the director to pay to the creditor (under s. 588K) is equal to the creditor's loss.

(iii) Liability does not attach to individual directors in proportion to their specific involvement but attaches to all directors on the basis of joint and several liability (although a director may have a particular defence that lessens or absolves civil or criminal responsibility).

(iv) There is no specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. The company must, however, have been insolvent at the time.

(v) The defences available are:[22]

(A) in relation to civil liability under sections 588G(2) and 588M – expecting solvency on reasonable grounds, including reasonable reliance on a qualified person for advice; illness or other good reason preventing

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18 Possibly in conjunction with a compensation order under s. 588K.

19 Section 588N states: "An amount recovered in proceedings under section 588M in relation to the incurring of a debt by a company is to be taken into account in working out the amount (if any) recoverable in any other proceedings under that section in relation to the incurring of the debt".

20 Australian Securities and Investments Commission - the corporate watchdog.

21 Through the liquidator.

22 Note that the "business judgement rule" in s.180(2) does not provide a defence to an insolvent trading claim (see below, n 27 and accompanying text, and note to s. 180(2)).

director from managing the company at the time; or having reasonably tried to prevent the debt being incurred (s. 588H);

(B) in relation to criminal liability – lack of dishonesty or lack of suspicion of insolvency, which, while not being explicit defences, would mean that the elements of the offence are not satisfied (sections 588G(3)(c) and 588G(3)(d)); and

(C) in relation to penal liability[23] – lack of material prejudice to the company's or shareholders' interests and to the company's ability to pay its creditors, together with lack of seriousness of the contravention;[24] in addition, the above mentioned defences available in civil proceedings (s. 588H) apply here as well.[25]

Note 1: Division 5 of Part 5.7B (sections 588V-588X) provides that a holding company can be liable for the insolvent trading of a subsidiary. However, the *Corporations Act* does not make the directors of the holding company personally liable.

Note 2: A person managing a company while disqualified from acting as a director (under s. 206A) may become personally liable for the company's debt (s. 588Z).

2.3 Failing to exercise care and diligence: s. 180

(i) Liability of a director may be both civil (s. 1317H) and criminal (s. 1311), and there is liability for a pecuniary penalty order under s. 1317G.[26]

Civil penalty proceedings are not to be taken, or are to be dismissed, if criminal proceedings resulted in a conviction: sections 1317M and 1317N. However, criminal proceedings may be taken after civil penalty proceedings regardless of outcome: s. 1317P.

(ii) A director can be made personally liable in respect of the whole of the loss caused to the company (including profits made by anyone as a result of insolvent trading). A director may also have to pay a fine to the Commonwealth.

(iii) Liability will attach to specific directors in the sense that it will be imposed on the particular director(s) in breach.

(iv) There is no specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. Further, it is not necessary to show that the company was insolvent at the time.

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23 That is, liability which arises from a contravention of a civil penalty provision of the Corporations Act (see above, n 17).

24 Again, this is not an explicit defence, but the way in which the elements of s. 1317G might not be satisfied. Note that, even if a pecuniary penalty order is not imposed as a result, a compensation order may still be imposed under s. 1317H.

25 Further, a director who has contravened a civil penalty provision may seek relief from liability if he or she acted honestly and ought fairly to be excused: s. 1317S (see also s. 1318 which provides similar relief, but is not restricted to breaches of civil penalty provisions).

26 That is, a quasi-penal order.

(v) The defences available to a director are:

(A) proper “business judgement”[27] exercised: s. 180; and

(B) reliance on proper delegation: s. 190 (see also s. 189 – reliance on information or advice provided by others).

In addition, in civil penalty proceedings, lack of material prejudice to the company’s or shareholders’ interests and to the company’s ability to pay its creditors, together with lack of seriousness of the contravention, is the way in which the requirements of s. 1317G might not be satisfied, and hence a civil penalty order not imposed (but a compensation order may still be imposed under s. 1317H).[28]

2.4 Not acting in good faith, misuse of position and misuse of company information: sections 181-183

(i) Liability of a director may be both civil (s. 1317H) and criminal (s. 184), and there is liability for a pecuniary penalty order under s. 1317G.[29]

Civil penalty proceedings are not to be taken, or are to be dismissed, if criminal proceedings resulted in a conviction: sections 1317M and 1317N. However, criminal proceedings may be taken after civil penalty proceedings regardless of outcome: s. 1317P.

(ii) A director can be made personally liable in respect of the whole of the loss caused to the company (including profits made by anyone as a result of insolvent trading). A director may also have to pay a fine to the Commonwealth.

(iii) Liability will attach to specific directors in the sense that it will be imposed on the particular director(s) in breach.

(iv) There is no specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director, although the matter is covered by the general legislation, which imposes limitation periods. Further, it is not necessary to show that the company was insolvent at the time.

(v) Reliance on proper delegation is a defence available to a director: s. 190 (see also s. 189 – reliance on information or advice provided by others).

In addition, in civil penalty proceedings, lack of material prejudice to the company’s or shareholders’ interests and to the company’s ability to pay its creditors, together with lack of seriousness of the contravention, is the way in which the requirements of s. 1317G might not be satisfied, and hence a civil penalty order not imposed (but a compensation order may still be imposed under s. 1317H).[30]

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27 This will occur where the directors have acted in good faith and for a proper purpose, had no material personal interest, properly informed themselves, and had a rational belief that they acted in the interests of the company (s. 180(2) - the “business judgement rule”). Note that this defence is only available in proceedings under s. 180; in particular, it is not a defence to an insolvent trading claim (see note to s. 180(2)).

28 See above, n 25.

29 That is, a quasi-penal order.

30 See above, n 25.

2.5 Entering into an agreement or transaction to avoid employee entitlements in breach of s. 596AB[31]

(i) Liability of a director may be:

(A) civil (s. 596AC); and

(B) criminal (s. 588G(3)[32] if insolvent trading to a criminal degree is also involved, or s. 1311 otherwise).

There is to be no double recovery (sections 588N and 596AD).

(ii) Whether the liquidator or an employee[33] applies, the director is personally liable in respect of the loss suffered by the employee.

Note that s. 596AB is not a civil penalty provision, so ASIC cannot apply for relief.

If insolvent trading is involved and criminal proceedings are taken under s. 588G(3), the compensation that the court may require the director to pay to the creditor (who may be the employee) under s. 588K is equal to the creditor's loss

(iii) Liability does not attach to individual directors in proportion to their specific involvement. Each director can be ordered to pay the whole amount, although an individual director may have a particular defence that lessens or absolves civil or criminal responsibility.

(iv) There is no specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. Further, it is not necessary to show that the company was insolvent at the time.

(v) Defences are only available if a linked contravention of s. 588G is also present, and they are the same as for the breach of s. 588G (see above, p 23).

2.6 Causing or allowing the company to make a payment of money to the Commissioner of Taxation that is later found to be a preference under s. 588FE: s. 588FGA

(i) Liability of a director is civil (s. 588FGA).

(ii) The director can be made liable for the whole of the loss or damage suffered by the Commissioner as a result of the payment to the Commissioner being set aside under s. 588FF.

(iii) Liability does not attach to individual directors in proportion to their specific involvement but attaches to all directors on the basis of joint and

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31 A person may incur a liability under s. 596AB and under s. 588G from the one breach, in which case the contraventions of the two provisions are defined as "linked" (sections 9 and 596AB(4)), and no double recovery is possible (see sections 588N and 596AD).

32 Possibly in conjunction with a compensation order under s. 588K.

33 Under s. 596AC(3) as permitted by s. 596AF or s. 596AH (and not prevented by s. 596AI).

several liability (although a director may have a particular defence that lessens or absolves responsibility).

(iv) Liability only arises if the payment to the Commissioner of Taxation was made within a certain period (determined by reference to s. 588FE) before or after the relation-back day.

(v) The defences available to a director are:

(A) expecting solvency on reasonable grounds, including reasonable reliance on a qualified person for advice: sections 588FGB(3) and 588FGB(4);

(B) illness or other good reason preventing director from managing the company at the time of payment to the Commissioner of Taxation: s. 588FGB(5); and

(C) reasonable steps taken to prevent the debt being incurred or the absence of reasonable steps that could have been taken: s. 588FGB(6).

See also s. 588FG, which provides defences to the Commissioner of Taxation against an order setting aside the company's tax payment. Briefly, the provisions protect an innocent person who either received no benefit as a result of the tax payment, or received a benefit in good faith without grounds to suspect the company's insolvency. If the Commissioner of Taxation successfully argues one of these defences, the payment is not set aside and the director is not personally liable.

2.7 Falsification of books; false and misleading statements and information: sections 13071309

(i) Liability of a director is criminal (s. 1311).

(ii) Since liability is criminal, the penalty does not depend on the damage caused.

(iii) Liability will attach to specific directors in the sense that it will be imposed on the particular director(s) in breach.

(iv) There is no specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. Further, it is not necessary to show that the company was insolvent at the time.

(v) Depending on the particular offence, the following defences may be available:

(A) lack of intention to falsify books: s. 1307(3);[34]

[34] This is the only explicit defence. The others in this list are simply ways in which the elements of an offence might not be satisfied.

(B) acting honestly;

(C) lack of knowledge that information is false or misleading; and

(D) having taken reasonable steps to ensure the statement was not false or misleading.

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3. Others liable in respect of the company's activities during the "twilight" period

3.1.1 The *Corporations Act* specifies general duties of officers[35] of a company which will apply to their conduct during the "twilight" period.[36]Employees may also be liable for misuse of their position or information during and outside the "twilight" period.[37]

3.1.2 The *Corporations Act* also applies to a person who is not validly appointed as a director if:

(a) he or she acts in the position of a director; or

(b) the directors of the company are accustomed to act in accordance with his or her instructions or wishes.[38]

This person will be *deemed* to be a "director" for the purposes of the *Corporations Act*.

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[35] Section 9 defines "officer" to include a director, secretary or a person participating in decision-making affecting the whole or a substantial part of the business of the corporation and includes receivers, administrators and liquidators.

[36] Note that these duties also apply to conduct outside the "twilight" period. In fact, apart from sections 588FE, 588FF, 588G, 588M and 588V 588W, none of the provisions mentioned in the answer to this question are limited to conduct during the "twilight" period.

[37] Sections 182 and 183.

[38] Section 9 (definition of "director"). This is in similar terms to the previous s. 60 definition of "director" which included "shadow directors".

3.1.3 Under s. 596AB, a "person" may be liable for entering into an agreement to avoid or reduce employee entitlements. A "person" guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a company may have imposed upon him or her any order that the court thinks appropriate if the corporation suffers loss or damage: s. 598.

3.1.4 Division 5 of Part 5.7B (sections 588V-588X) provides that a holding company can be liable for the insolvent trading of a subsidiary.

3.1.5 A person managing a company while disqualified from acting as a director may become personally liable for the company's debt (s. 588Z).

3.1.6 Some sections of the *Corporations Act* create liability not only for those contravening a provision (eg directors if the provision imposes requirements on directors), but also for persons involved in the contravention.[39]

3.1.7 Finally, third parties may be held liable to repay the liquidator any benefit they received as a result of an act of the company during the "twilight" period: s. 588FF(1).

3.2 Acts in respect of which other persons may be held liable

3.2.1 A person who is deemed to be a "director" may be held liable for any of those acts identified in question 2 above, that is, acts which may give rise to personal liability on the part of directors.[40]

3.2.2 An officer of a company will be subject to the duties contained in sections 180-183.[41] An officer performing an act in contravention of those duties will therefore be liable. An officer will also be criminally liable for obtaining credit for the company by fraud (s. 596(a)), transferring company property with intention to defraud (s. 596(b)), various offences under s. 590, falsification of books (s. 1307) and furnishing misleading information (s. 1309). Liability will be the same as it would be for a director.

3.2.3 Liability of a "person" involved in another person's contravention of s. 181, 182 or 183 (ie failure to act in good faith, misuse of position or misuse of information) is the same as it would be for that other person.

3.2.4 A third party may be liable to repay the company's liquidator if the liquidator seeks orders that certain transactions entered into by the company with the third party during the "twilight" period are voidable.[42] The court may make a variety of orders;[43] including that the third party pay an amount equal to some or all of the money the company has paid under the transaction (s. 588FF(1)(a)) or an amount which fairly represents some or all of the benefits the person has received because of the transaction (s. 588FF(1)(c)).

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[39] For example, see sections 181-183. The word "involved" is defined in s. 79.

[40] That is, their liability will be the same as for a validly appointed director.

[41] Sections 180 - 183 of the Corporations Act set out duties of care and diligence (s. 180(1)), good faith (s. 181), use of position (s. 182) and use of information (s. 183). Note that sections 182 and 183 also apply to employees of the company.

[42] Section 588FE provides that certain transactions are voidable (unfair preferences, uncommercial transactions, insolvent transactions and unfair loans to a company).

[43] Section 588FF.

3.2.5 Under s. 596AB, a "person" may be liable for entering into an agreement to avoid or reduce employee entitlements. A "person" may also be criminally liable for producing (or contributing to) misleading documents (s. 1308). Liability is the same as it would be for a director. Liability of a "person" (under s. 598) for fraud, negligence, default, breach of trust or breach of duty is entirely within the court's discretion, but may be related to the corporation's loss or damage.

3.2.6 Division 5 of Part 5.7B (sections 588V-588X) provides that a holding company can be liable to compensate loss or damage caused by the insolvent trading of a subsidiary.

3.2.7 A person managing a company while disqualified from acting as a director may become personally liable for the company's debt (s. 588Z).

3.3 Limitation of liability

3.3.1 Whether liability will be limited to that resulting from involvement with a particular transaction, or relates more generally to the overall loss suffered by creditors, will depend upon the particular provision of the *Corporations Act* under consideration.

3.3.2 For example, a person who has received an unfair preference may be ordered to pay to the company an amount equal to some or all of the money that the company has paid under the transaction (s. 588FF(1)(a)). The person's liability will then be limited under s. 588FF(1)(a) to the loss resulting from that particular transaction.

3.3.3 In an action for breach of a civil penalty provision (such as s. 588G(3) or sections 180-183), liability pursuant to a compensation order is for an amount up to the loss or damage resulting from the particular contravention, including profits made by anyone as a result of the contravention: s. 1317H.

3.3.4 In an action against a director (or a deemed director)[44] for breach of his or her duty to prevent insolvent trading, a liquidator may recover from the director as a debt an amount equal to the amount of the loss or damage resulting from the company continuing to trade whilst insolvent (s. 588M(2)). Recovery in this case is limited to a particular transaction, but in practice liquidators pursue claims relating to several (though not necessarily all) transactions at the same time. This has the effect of allowing recovery of overall loss suffered by some or all creditors from the point in time when the director is found to have allowed the company to continue to trade whilst insolvent.

3.3.5 The same reasoning applies to liability of a holding company for its subsidiary's insolvent trading under sections 588V-588X.

3.3.6 Similarly, liability for breach of s. 596AB is limited to the loss to a single employee resulting from a particular transaction. However, where action is taken by a liquidator, claims relating to several employees and transactions may be pursued at the same time.

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[44] Because the definition of "director" in s. 9 includes deemed directors, the liability of a deemed director will always be the same as the liability of a validly appointed director would be in the same circumstances.

3.3.7 Liability (under s. 588Z) of a person who manages the company while disqualified is within the court's discretion but is connected to the company's debts and liabilities. The court is likely to impose liability that bears some relation to (but may not be equal to) those debts and liabilities incurred by the company while the person was disqualified and managing the company.

3.3.8 Liability (under s. 598) of a person guilty of fraud, negligence, default, breach of trust or breach of duty is also within the court's discretion. One of the possible orders is the order for repayment of the loss or damage suffered by the corporation as a result of the fraud, negligence, default or breach.

3.3.9 Where liability is criminal or a pecuniary penalty order is made, a fine is payable to the Commonwealth. At best, the loss resulting from the particular contravention may be indirectly taken into account when setting the amount of the fine.

3.3.10 Sections 181-183 impose liability on a person who is involved in another person's contravention. The first person's liability will normally be limited (if at all) in the same way as the liability of that other person.

QUESTION 4

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4. Counter-parties dealing with the company during the "twilight" period

(a) From the point of view of a counter-party dealing with the company during the "twilight" period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Heads of challenge which may lead to counter-party[45] transactions being set aside

4.1.1 A creditor may be ordered to repay an unfair preference which occurred during the 6 month period ending on the relation-back day or after that day but on or before the day when the winding up began. This time period is increased to 4 years if a related entity is involved and 10 years if the purpose of the payment was to defeat creditors.[46] A creditor may be ordered to forego the benefit of an uncommercial transaction during the 2 years ending on the relation-back day.

The challenge can only be made if the company is insolvent.

4.1.2 A loan to a company at any time on or before the day when the winding up began may be determined to be unfair (s. 588FD) and set aside.

[45] The expression "counter-party" is not used in Australian law; rather the expression "third party" is used.
[46] See table in question 1.

4.1.3 In any of these cases the court may make a range of orders under s. 588FF, including the payment of money and the transfer of property.

4.1.4 The benefit of a voidable transaction that discharges a liability of a related entity can be recovered from that entity by the liquidator.[47]

4.1.5 A floating charge created within 6 months before the relation-back day (or after that day but on or before the day the winding up began) is void against the company's liquidator except in so far as it secures certain advances (see 11.2.3), unless the company was solvent immediately after the charge was created.[48]

4.1.6 A general law claim may be made against a counterparty where it received the benefit of a transaction undertaken by the directors of an insolvent or near insolvent company in breach of their duty to that company.

4.2 Defences available to a counter-party seeking to protect a transaction from being attacked

4.2.1 Defences to orders against voidable preferences are contained in s. 588FG:

(a) a non-party is not to be the subject of an order materially prejudicing its interests if that party received no benefit, or the benefit was received in good faith and there were no reasonable grounds to suspect the company's insolvency; and

(b) a party (other than the recipient of an unfair loan) is not to be the subject of an order materially prejudicing its interests if it acted in good faith, there were no reasonable grounds to suspect the company's insolvency, and the party provided valuable consideration or changed its position in reliance on the transaction.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in question 3 above)?

5.1 The company

5.1.1 Whilst not exclusively relevant to the "twilight" period, the company is the appropriate applicant for any breach of the statutory duties of directors and other officers and employees described in answer to questions 2 and 3 above, or for any breach of the general law duty of directors to exercise their powers

47 Section 588FH.
48 Section 588FJ. See further the answer to question 11(b).

in the best interests of the company as a whole. The liquidator has power by reason of s. 477(2)(a) of the *Corporations Act* to bring proceedings in the name of the company.

5.1.2 The company is also the appropriate applicant for relief where the claim is in respect of a breach of the general law duty of directors of companies which are insolvent, near insolvent or of doubtful solvency to exercise their powers having regard to the interests of that company's creditors.[49]

5.1.3 Finally, the company may apply for a compensation order if a civil penalty provision has been breached: s. 1317J.

5.2 The liquidator

5.2.1 In the event that the court exercises its power under s. 474(2) to vest property of the company (including the company's claims, eg against the directors) in its liquidator, the liquidator may bring proceedings on account of the company's claims in the liquidator's own name.

5.2.2 It is the liquidator, rather than the company, who may bring a claim against a director for breach of the duty to prevent insolvent trading[50] and for causing the company to undertake a transaction which has the purpose of defeating claims by employees to their entitlements.[51]

5.2.3 The liquidator also has a statutory right to bring proceedings against those guilty of fraud, negligence, default, breach of duty or breach of trust in relation to the company.[52]

5.2.4 It is also the liquidator of the company who may seek recovery from an entity related to the company (which may be a director) in respect of that entity's liability discharged as the result of a voidable insolvent transaction.[53]

5.3 Shareholders

5.3.1 Proceedings for breach of duty to a company are generally only available to the company itself, which is separate from its shareholders – this is referred to as the rule in *Foss v Harbottle*.[54] No relevant exception to the rule applies in the particular circumstance of a breach of duty by a director of the company, or some other person concerned in its management, during the "twilight" period**.** In circumstances where a liquidator or other external administrator has been appointed to the company.

5.4 Creditors

5.4.1 As with shareholders, it is generally the case that creditors (including employees) may not bring proceedings for a breach of duty against directors of a company or others concerned in its management.

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[49] See above, n 8.
[50] Section 588M(2).
[51] Section 596AC(2).
[52] Section 598(2). See also definition of "eligible applicant" in s. 9.
[53] Section 588FH.
[54] (1843) 67 ER 189.

5.4.2 However, in certain circumstances, creditors may be entitled to bring proceedings against directors of a company for breach of the duty to prevent insolvent trading.[55]

5.4.3 Employees may also make claims against a person who has caused the company to undertake transactions with the intention of preventing the company from discharging its obligations to those employees in respect of the employees' entitlements.[56]

5.4.4 The Commissioner of Taxation may bring an action to recover from the director an amount paid to the Commissioner by the company, if that amount is later found to be a preference: s. 588FGA.

5.5 Government or regulatory authorities

5.5.1 The Commissioner of Taxation (a statutory officer under the *Income Tax Assessment Act 1936* (Cth) ("Tax Act")) may recover his losses in an insolvency administration by bringing claims against directors as a result of the failure on the part of the company to remit certain taxes.

5.5.2 Most claims will be brought under a regime established by the Tax Act. In essence the operation of those provisions requires:[57]

(a) a failure by the company to remit the amount of taxes which it has deducted from payments made by the company (group tax);

(b) the service upon the directors of the company of notices requiring them to either remedy that default or take other prescribed action, including putting the company into some form of insolvency administration; and

(c) a failure on the part of the directors to comply with that notice within 14 days.

5.5.3 Further, where the director causes or allows the company to make a payment of money to the Commissioner of Taxation that is later found to be voidable under s. 588FE such that an order under s. 588FF is made by a court against the Commissioner for repayment of the money to the liquidator, the director can be liable to indemnify the Commissioner for his loss under s. 588FGA.

5.5.4 Whilst it is not finally resolved that the incurring of liabilities for taxes and duties can involve a breach of the duty to prevent insolvent trading, if it does, then the revenue authorities, as is the case with other creditors, may be able to bring proceedings under s. 588M(3) for unpaid taxes and duties.

5.5.5 Beyond these particular circumstances, government and regulatory authorities are limited to the prosecution of criminal and quasi criminal proceedings against directors.

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[55] Sections 588R, 588S, 588T and 588U.

[56] Sections 596AF, 596AG, 596AH and 596AI.

[57] See Division 9 of Part VI (sections 222ANA-222AQD) of the Tax Act.

5.5.6 For example, in relation to contraventions of civil penalty provisions, ASIC may apply[58] for a declaration of contravention, a pecuniary penalty order or a compensation order. ASIC may also bring proceedings against those guilty of fraud, negligence, default, breach of duty or breach of trust in relation to the company.[59]

5.5.7 In relation to an alleged contravention of a minor offence, ASIC may issue a penalty notice requiring the alleged offender, within a specified time of at least 21 days, to pay a penalty and (if applicable) stop committing the offence. If the recipient complies with the notice, no criminal proceedings are issued.[60]

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 In respect of contraventions committed during the “twilight” period, the remedies are:

(a) for the liquidator – recovery in respect of the loss or damage suffered by the creditor(s) (s. 588M(2)), employee(s) (s. 596AC(2)) or the company[61] (s. 1317J); recovery from a related entity (s. 588FH(2)), a holding company (s. 588W) and a person managing the corporation while disqualified (s. 588Z); recovery from a chargee where a void floating charge was discharged (s. 588FJ(6)); orders in respect of voidable transactions (s. 588FF);

(b) for the creditor – recovery in respect of its loss or damage (s. 588M(3));

(c) in respect of an employee – compensation equal to the employee’s loss or damage (s. 596AC(3)); and

(d) for the ASIC - compensation equal to the loss or damage (sections 588J and 1317J), a pecuniary penalty (s. 1317J), a declaration of contravention of a civil penalty provision (s. 1317J) or a disqualification order (s. 206C).

6.2 In respect of a claim by the Commissioner of Taxation under s. 588FGA, section 588FGA(4) allows an order to be made for indemnity by the directors in respect of the Commissioner’s loss or damage, which is recoverable as a debt due to the Commonwealth.

6.3 ASIC or the Director of Public Prosecutions may lay charges where a criminal offence is alleged. Remedies are generally fines and/or imprisonment.[62]

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58 Under s. 1317J.

59 Section 598. See also definition of “eligible applicant” in s. 9.

60 Section 1313.

61 The liquidator must be suing in the name of the company.

62 Alternatively, where the alleged offence is minor, ASIC may issue (under s. 1313) a penalty notice requiring the alleged offender, within a specified time of at least 21 days, to pay the penalty and (if applicable) stop committing the offence. If the recipient complies with the notice, no criminal proceedings are instituted.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (eg in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Extent to which directors are obliged to co-operate with an investigation into the company's affairs following its insolvency

7.1.1 Directors and certain other persons connected with the company are required to provide a liquidator with a report as to the company's affairs as at the date of its winding up. That report is, in essence, a listing of the company's assets and liabilities. A further obligation exists to provide such additional information as the liquidator requires by notice in writing given to the relevant persons.[63]

7.1.2 There is also a positive obligation on officers of the company to deliver books and records to the liquidator, and to give any information and assistance reasonably required by the liquidator.[64]

7.1.3 Whilst a breach of those obligations is punishable as an offence (s. 1311), as a matter of practice, if a liquidator wishes to pursue information, she or he will rely upon the examination provisions of the *Corporations Act* which allow a court to summon a person for examination about a company's affairs.[65]

7.1.4 Where a prosecution in respect of an offence under the *Corporations Act* has been instituted against a person, ASIC may require any person who is or was a partner, employee or agent of the defendant to assist in the prosecution by giving "all assistance in connection with the prosecution that the person is reasonably able to give" (s. 1317(1), and see also s. 1317R, which applies both to criminal and quasi-penal proceedings, and imposes requirements on a wider range of persons).

7.1.5 Finally, s. 1310 prohibits a person from obstructing or hindering (without lawful excuse) ASIC or anyone else in the performance or exercise of a function or power under the *Corporations Act*.

[63] Section 475.
[64] Section 530A.
[65] Sections 596A and 596B.

7.2 Applicable human rights laws

7.2.1 The discussion here is limited to the privilege against self-incrimination.

7.2.2 Australia is a signatory to the *International Covenant on Civil and Political Rights* ("ICCPR"). Under Article 14.3(g) of the ICCPR, a person charged with a criminal offence shall not "be compelled to testify against himself or to confess guilt". This right may be relied upon by directors under question during investigation of the company. The ICCPR, "while having no force [as law] in the Australian municipal law, nevertheless provides an important influence on the development of the Australian common law".[66]

7.2.3 Under Australian law the privilege against self-incrimination is not considered to be merely a rule of evidence governing the admissibility of evidence in judicial or quasi-judicial proceedings. In the words of Mason CJ and Toohey J in *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477:

> The privilege in its modern form is in the nature of a human right, designed to protect individuals from oppressive methods of obtaining evidence of their guilt for use against them.

7.2.4 The privilege does not apply during ASIC investigations, ie a person cannot rely on it in refusing to provide information or a document. However, where the person claims privilege in respect of any incriminating information or document before providing it to ASIC at the investigation, the information or document is not admissible as evidence against the person in a criminal proceeding or a proceeding for the imposition of a penalty (except for proceedings concerned with the falsity of such information or document).[67]

7.2.5 Similar rules apply in relation to examining a person about a corporation under s. 597. Examinees are obliged to answer any question put to them in the context of such examinations notwithstanding that the answers may tend to incriminate them: s. 597(12). However, for so long as privilege is claimed in relation to any such answers, those answers may not be used in criminal proceedings (or proceedings for the imposition of a penalty) against the examinee other than proceedings concerned with the falsity of any such answer: s. 597(12A).[68]

7.2.6 It is settled law in Australia that the privilege is not available to artificial entities such as corporations.[69]

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[66] Environmental Protection Authority v Caltex Refining Co Pty Ltd (1993) 178 CLR 477.

[67] Section 68 of the Australian Securities and Investments Commission Act 1989 (Cth). Note that the protection given by s. 68 does not apply in civil proceedings.

[68] Note that the protection does not apply in civil proceedings.

[69] See above, n 66. See also s. 1316A.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods applying to actions brought against directors (and/or others identified in question 3) in connection with the offences described in question 2

8.1.1 Any proceeding brought with respect to voidable transactions pursuant to s. 588FF must be commenced within 3 years after the relation-back day or within such longer period as the court orders on an application by the liquidator within those 3 years (s. 588FF(3)).

8.1.2 It appears that actions against the directors by the Commissioner of Taxation pursuant to s. 588FGA (action for a debt) must be commenced within 6 years, being a period commonly prescribed by state laws.

8.1.3 Actions against directors by either a creditor or liquidator for recovery of compensation for loss resulting from insolvent trading must be commenced within 6 years after the beginning of the winding up: s. 588M(4).

8.1.4 Actions against persons who breach s. 596AB (agreements or transactions entered into to avoid employee entitlements) must be made within 6 years after the beginning of the winding up: s. 596AC(4).

8.1.5 An action against a holding company for recovery of loss resulting from a subsidiary's insolvent trading pursuant to s. 588V may only be commenced within 6 years after the beginning of the winding up (s. 588W).

8.1.6 If a civil penalty provision is breached, proceedings for a pecuniary penalty order or a compensation order may only be started within 6 years after the contravention: s. 1317K.

8.1.7 Criminal proceedings may be instituted within 5 years after the alleged offence: s. 1316. Penalty notices for alleged contraventions of minor offences[70] must also be issued within this time: s. 1313(2)(b).

8.2 Appeal from the decision of lower courts

8.2.1 The *Corporations Act* does not provide any time limits for appeals in penal, civil, criminal or disqualification proceedings.

[70] See above note 62.

8.2.2 The court in which the proceeding is decided will be determined by reference to the particular section of the *Corporations Act* pursuant to which the proceeding is brought. For example, where the relevant section of the *Corporations Act* refers to Court with a capital "C", that Court is defined in the *Corporations Act* (s. 58AA) as meaning any Federal Court, Supreme Court or Family Court (ie superior Court). Where the relevant section of the *Corporations Act* refers to court with a small "c", that court means any court exercising "*the jurisdiction of this jurisdiction*".[71]

8.2.3 If a matter is decided in the Supreme Court of a particular State or Territory, the time limit for any appeal would be governed by the rules of that particular Court. For example, in Queensland a party has 28 days after the date of a Supreme Court decision to file a Notice of Appeal (unless the Court of Appeal orders otherwise).[72]

8.2.4 In the Federal Court, a party has 21 days after the date on which the judgment was pronounced, or alternatively the date on which leave to appeal was granted, or such further time as the Court may allow, to lodge an appeal.[73]

8.2.5 A person who is disqualified from managing corporations may apply to the court for leave to manage a corporation, provided that the person was not disqualified by ASIC. However, before bringing the application for leave to manage the corporation, the person must lodge a notice in the prescribed form with ASIC at least 21 days before commencing the proceedings.[74]

QUESTION 9

9. Foreign corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 The provisions dealing with transactions in the "twilight" period[75] apply to both foreign and domestic companies.[76]

9.2 A "foreign company" (as defined in s. 9) must not carry on business in Australia unless it is registered or has applied to be registered (s. 601CD),[77]

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71 Section 58AA(1) of the Corporations Act and see also the Corporations Rules. Please note that the use of the words "court" and "Court" in this response to questionnaire does not necessarily adopt this distinction.

72 Rule 748 of the Uniform Civil Procedure Rules.

73 Order 52, Rule 15 of the Federal Court Rules.

74 Section 206G of the Corporations Act.

75 This encompasses all the provisions of the Corporations Act considered above, but may not necessarily include relevant provisions from other legislation.

76 See definitions of "corporation" (s. 57A), "company" and "foreign company" (s. 9).

77 On the other hand, the definition of "company" (within which a foreign company must come in order for the Corporations Act to apply to that foreign company) requires that the company be registered or "taken" to be registered. It is unclear what "taken to be registered" means, and unless it encompasses a foreign company that has only applied to be registered, the Corporations Act only applies to foreign companies that have already been registered.

but if a foreign company does carry on business in Australia, it is liable to be wound up by order of the Australian courts (s583).

QUESTION 10

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10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 Directors' and officers' liability insurance is available in Australia. Policies offer cover for "wrongful acts", typically failing to exercise diligent control over management and thus failing to safeguard against losses caused by reckless decisions and embezzlement. Cover is also available to the company itself if it pays out under an indemnity it grants to the director or officer.

10.2 Companies may pay the premium for policies taken out to cover directors' and officers' liabilities as long as cover is not provided for, among others, the following (other than for legal costs – see below):[78]

(a) wilful breaches of duty in relation to the company;

(b) conduct not in good faith;

(c) conduct resulting in a pecuniary penalty or compensatory order;[79]

(d) conduct involving improper use of position or information;[80] and

(e) a liability owed to the company (which may arise due to breaches of other duties).

Indemnity or insurance covering any of the above items is void: s. 199C.

10.3 Legal costs may be advanced to directors and officers facing proceedings involving allegations of these types. However, the costs must be repaid should there be a finding of fact against the director or officer: s. 199A(3). Directors may pay their own premiums to insure themselves against those liabilities against which the company is unable to insure.

10.4 In general, directors' and officers' policies do not specifically deny indemnity to companies or directors for liabilities arising from insolvent trading. However, on the ground of public policy, the policies do not allow for insurance against liabilities arising from directors' or officers' deliberate fraudulent acts or

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[78] Sections 199A and 199B of the Corporations Act.
[79] Such conduct is prohibited by sections 1317G and 1317H of the Corporations Act.
[80] Such conduct is prohibited by sections 182 and 183 of the Corporations Act.

omissions, wilful breaches of legislation and criminal acts. Arguably, insolvent trading that involves the directors in personal liability could come within these general exclusions, so that directors are not insured.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the "twilight" period?

11.1 How safe is it for directors or others involved with the company's affairs to incur further credit?

11.1.1 Insolvent trading provisions apply to "directors", defined to be persons:

(a) who are occupying, or acting in, the position of a director; or

(b) at whose directions or instructions the directors are accustomed to act.

11.1.2 In incurring further credit on behalf of the company during the "twilight" period, directors tread a very fine line. While they have a duty not to incur debts while the company is insolvent (s. 588G), insolvency is determined on a cash flow basis and the ability to raise further credit is an issue to be considered in that context.

11.1.3 In *Sandell v Porter*[81] the High Court of Australia stated that, in determining solvency, courts should take into account the debtor's ability to sell assets or borrow money within a relatively short time period.[82] The question of what time period is acceptable will depend on the circumstances of the case. In determining cash flow insolvency the courts have also made a distinction between insolvency and a temporary lack of liquidity.[83]

More recently in Australia Securities and Investments Commission v Plymin (2003) 46 ACSR 126 the following indicia of insolvency were identified.

1. Continuing losses
2. Liquidity ratios below 1.
3. Overdue Commonwealth and State taxes
4. Poor relationship with present Bank, including inability to borrow further funds.
5. No access to alternative finance.
6. Inability to raise further equity capital.
7. Suppliers placing [company] on COD, or otherwise demanding special payments before resuming supply.

81 (1966) 115 CLR 666.

82 Note that the Corporations Act defines a person to be "insolvent" when he or she is not solvent (s. 95A(2)), and a person is defined to be solvent "if, and only if, the person is able to pay all the person's debts, as and when they become due and payable" (s. 95A(1)).

83 See Hymix Concrete Pty Limited v Garrity (1977) 13 ALR 321 where it was held that a company's whole financial position must be considered and a temporary lack of liquidity does not necessarily mean insolvency.

8. Creditors unpaid outside trading terms.
9. Issuing of post-dated cheques.
10. Dishonoured cheques.
11. Special arrangements with selected creditors.
12. Solicitors' letters, summons[es], judgments or warrants issued against the company.
13. Payments to creditors of rounded sums, which are not reconcilable to specific invoices.
14. Inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

11.1.4 It is a defence to an action for insolvent trading that the directors had reasonable grounds to expect and did expect that the company was solvent at the time and would remain solvent if it incurred the relevant debt (s. 588H(2)).

11.2 Can an unconnected third party rely on the validity of transactions entered into with a company (in particular guarantees and securities) during the "twilight" period?

11.2.1 Generally, a third party is protected where the company obtains a genuine commercial benefit from the transaction. For instance, if security for debt is given at the time of incurring the debt, the security cannot be challenged later, but if the security is given for an earlier debt, this can be challenged by the liquidator.

11.2.2 Similarly, a floating charge which is created on the property of the company during the 6 months ending on the relation-back day (or after that day but on or before the day when the winding up began) is void against the company's liquidator unless the company was solvent immediately after the charge was created (s. 588FJ(1)).

11.2.3 However, s. 588FJ(2) provides that any such charge is not void in so far as it secures any of the following:

(a) an advance paid to the company, or at its direction, at or after the time the charge was created and as consideration for the charge;

(b) interest on such advance;

(c) the amount of a liability under a guarantee or other obligation undertaken at or after the creation of the charge on behalf of, or for the benefit of, the company;

(d) an amount payable for property or services supplied to the company at or after the creation of the charge; or

(e) interest on an amount so payable.

APPENDIX

Summary of Australian insolvency procedures and commercial issues

1. Summary of insolvency regime in Australia

1.1 The insolvency regime in Australia is divided into:

(a) insolvency of natural persons – see *Bankruptcy Act*; and

(b) insolvency of corporations – see *Corporations Act*.

1.2 Despite the split, disqualification and liability of directors of failed corporations is dealt with in the *Corporations Act*. The *Corporations Act* sets out the duties and liabilities of directors. Significantly, if the company has traded whilst insolvent, directors can be personally liable for debts incurred by the company when the company had no reasonable likelihood of being able to pay all its debts. In addition, taxation legislation imposes personal liability on directors for some of their company's unpaid tax debts, subject to the protection that directors can obtain by putting the company into administration or liquidation.

1.3 Directors of failed companies can also be disqualified from becoming directors for a period of time which varies according to the circumstances. A common period is 1-2 years.

1.4 Summary of insolvency procedures for corporations

1.4.1 Voluntary administration

If, in the opinion of its directors, a company is solvent (i.e., unable to pay all of its debts as and when they fall due) or is likely to become insolvent, they may resolve to appoint an administrator. The administrator is required to call meetings of creditors and report to them. On the basis of those reports, the creditors vote on three options:

(a) enter into a deed of company arrangement with the creditors of the company, which may allow the continued operation of the company and provide scope for considerable flexibility in allowing the company to restructure its affairs;

(b) be wound up (also known as "liquidation"); or

(c) return control of the company to the directors (this is rare).

No court involvement is required, although any interested party such as the administrator or a creditor can apply to the court for a wide range of supervisory orders.

1.4.2 Liquidation of the company

This is also known as winding up. This can be by a voluntary process instigated by the shareholders or the creditors, or by an involuntary process through court order. Through each of these processes a liquidator is appointed whose role is to realise the assets of the company and distribute proceeds to creditors in accordance with statutory priorities. A liquidator has the right to avoid some transactions entered into before winding up.

1.4.3 Receivership

Secured creditors stand outside voluntary administration and winding up. While the right of secured creditors to realise their security might be temporarily delayed by a voluntary administration or a winding up, they do not lose that right. A secured creditor usually appoints a receiver to an insolvent company with first right over the assets of that company until the debt of the secured creditor is paid in full. The court also has power, separately from a secured creditor, to appoint a receiver where the court considers it appropriate to do so.

2. Summary of commercial issues

2.1 Directors of companies in liquidation can be exposed to personal liability.

2.2 Relatively few actions are taken against directors for insolvent trading.

2.3 One reason why such actions are not commonplace is that they are expensive to run and can become complex, for example, in that insolvency of the company at various times needs to be proved by expert evidence. Another reason is that actions for insolvent trading are available only where a company is in liquidation. One major purpose of the voluntary administration procedure is to avoid liquidation.

2.4 On the other hand, litigation insurance is available to insolvency practitioners who have minimal or no funds in the administration. This can increase the threat to directors. The Commissioner of Taxation is increasingly more ready to pursue his own remedies against directors of failed companies.

2.5 There are recent examples of the Australian Securities and Investments Commission (ASIC – the corporate watchdog) itself pursuing high profile directors where companies have failed.

2.6 ASIC is also active in taking steps to disqualify directors, although this action usually takes place well after the winding up has concluded.

2.7 The courts have generally been realistic in the retrospective review of the conduct of directors. They understand that business involves risk and they are reluctant to stifle entrepreneurship on the part of directors.

2.8 At the same time, the courts have shown no tolerance for passive directors who leave the hard work to others and claim that they did not know what was happening.

2.9 Liquidators have demonstrated an aggressive attitude to litigation, in particular with litigation insurance available. Preference actions are commonplace (in Australia there is no requirement to prove an intention to prefer a creditor). These do not, however, universally result in a net return to creditors.

2.10 After the liquidator's remuneration, secured creditors and priority creditors (for example employees) are paid, returns to unsecured creditors are minimal or (if the company's assets have been completely depleted) non-existent. Thus unsecured creditors are generally supportive of the voluntary administration procedure, which is intended to keep the business trading. The return from such a procedure is often better than that which would be achieved in a winding up.

BERMUDA

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 Bermuda law provides statutory remedies in relation to 'clawback' provisions. Generally the key issue is whether the company was 'insolvent' at the time (or as a result) of the relevant transaction.

"Insolvent" for these purposes means the moment at which the company becomes unable to pay its debts as they fall due - the "cash-flow" test

1.1.2 It is important to note that a director's general duty to act in the best interests of the company has a different content when a company is 'insolvent'. In that context the word "insolvent" means that the liabilities of a company exceed its assets). In these circumstances, the directors must exercise their powers and discharge their duties with a view to minimizing the potential loss to creditors as opposed to acting in the best interests of the collective body of shareholders.

1.1.3 The "twilight period" generally ends when a formal insolvency procedure commences[1].

1.1.4 The various vulnerability periods for the Bermuda law clawbacks, being periods prior to the commencement of a formal insolvency, are as follows:

(a) preferences (eg. security, charges) - 6 months, s237;

(b) voidable floating charges - 12 months, (s239);

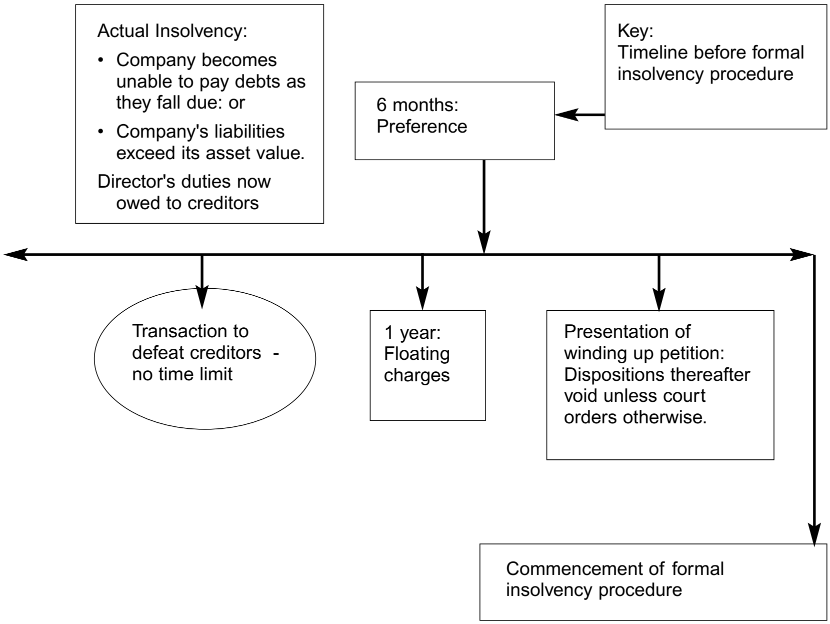
(c) transactions at an undervalue (eg. guarantees) - two years (s36A,) Conveyancing Act 1993;

(d) dispositions after winding up petition - from date of petition (s. 166).

Whilst these provisions are considered in more detail in reply to question 4, we set out below a "time line" summarising the statutory provisions mentioned above.

1 This will generally be the date on which the winding up petition was issued upon which the court ultimately made an order that the company enter the insolvency procedure involved or, in the case of a voluntary procedure, the date on which a resolution was passed by the company to pursue that voluntary procedure.

1.2 Summary



1.2.1 If a company is balance sheet or cash-flow insolvent and within a vulnerability period (usually six months) and enters a formal insolvency procedure (e.g. liquidation), transactions such as new charges, guarantees or sales of assets at less than market value may be vulnerable to attack by the liquidator.

QUESTION 2

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2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

2.1 Fraudulent Trading[2]

(a) This applies where a company is being wound up and it is shown that the business of the company has "been carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose". The elements of the concept are therefore, as follows:

(i) there has to be an insolvent liquidation in progress;

(ii) there has to have been dishonesty in the running of the business as that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose;

(ii) as dishonesty is involved, the standard of proof is that of 'beyond reasonable doubt', even in a case of civil liability;

(iv) it applies to persons who are "knowingly parties" to the fraudulent trading

(b) (i) Liability may be criminal or civil.

(ii) The court enjoys a wide discretion to compensate for the loss caused to the company by the director's conduct. The section provides that a person found liable shall be personally responsible, without any limitation of liability, for all or any of the debts or other liability of the company as the Court may direct.

(iii) There is no specified period.

(iv) The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full. It is worth noting that it is rare for persons to be found liable for fraudulent trading.

[2] Section 246 Companies Act 1981

2.2 Fraud by officers of companies which have gone into liquidation[3]

(a) If any person, being at the time of the commission of the alleged offence an officer of a company which is subsequently ordered to be wound up by the Court or subsequently passes a resolution for voluntary winding up, -

(i) has by false pretence or by means of any other fraud induced any person to give credit to the company;

(ii) with intent to defraud creditors of the company, has made or caused to be made any transfer of or charge on, or has caused or connived at the levying of any execution against, the property of the company; or

(iii) with intent to defraud creditors of the company, has concealed or removed any part of the property of the company since, or within two months before, the date of any unsatisfied judgment or order for payment of money obtained against the company, shall be liable to either on indictment to imprisonment for a term of two years, or on summary conviction to imprisonment for a term of twelve months.

(b) If any of (a) - (c) above are satisfied:

(i) Liability is criminal.

(ii) A person guilty of this offence is liable to imprisonment.

(iii) The gravity of the wrongdoing will be reflected in the length of imprisonment. In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

2.3 Offences by officers of companies in liquidation[4]

If any person, being a past or present officer of a company which at the time of the commission of the alleged offence is being wound up, whether by the Court or voluntarily, or is subsequently ordered to be wound up by the Court or subsequently passes a resolution for voluntary winding up—

(a) does not to the best of his knowledge and belief fully and truly discover to the liquidator all the property, real and personal, of the company, and how and to whom and for what consideration and when the company disposed of any part thereof, except such part as has been disposed of in the ordinary way of the business of the company; or

(b) does not deliver up to the liquidator, or as he directs, all such part of the real and personal property of the company as is in his custody or under his control, and which he is required by law to deliver up; or

(c) does not deliver up to the liquidator, or as he directs, all books and papers in his custody or under his control belonging to the company and which

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[3] Section 245 Companies Act 1981

[4] Section 243 (1) Companies Act

he is required by law to deliver up;

(d) within twelve months next before the commencement of the winding up or at any time thereafter conceals any part of the property of the company to the value of three hundred dollars or upwards, or conceals any debt due to or from the company; or

(e) within twelve months next before the commencement of the winding up or at any time thereafter fraudulently removes any part of the property of the company to the value of fifty dollars or upwards; or

(f) makes any material omission in any statement relating to the affairs of the company; or

(g) knowing or believing that a false debt has been proved by any person under winding up, fails for the period of a month to inform the liquidator thereof; or

(h) after the commencement of the winding up prevents the production of any book or paper affecting or relating to the property or affairs of the company; or

(i) within twelve months next before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies, or is privy to the concealment, destruction, mutilation or falsification of, any book or paper affecting or relating to the property or affairs of the company; or

(j) within twelve months next before the commencement of the winding up or at any time thereafter makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company; or

(k) within twelve months next before the commencement of the winding up or at any time thereafter fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with, altering or making any omission in, any document affecting or relating to the property or affairs of the company; or

(l) after the commencement of the winding up or at any meeting of the creditors of the company within twelve months next before the commencement of the winding up attempts to account for any part of the property of the company by fictitious losses or expenses; or

(m) has within twelve months next before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtained any property for or on behalf of the company on credit for which the company does not subsequently pay for; or

(n) within twelve months next before the winding up or any time thereafter, under false pretence that the company is carrying on its business, obtains on[ii] credit, for or on behalf of the company, any property which the company does not subsequently pay for; or

(o) within twelve months next before the commencement of the winding up or at any time thereafter pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging, or disposing is in the ordinary way of the business of the company; or

(p) is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them to an agreement with reference to the affairs of the company or to the winding up,

he shall, in the case of the offences mentioned respectively in paragraphs (m), (n) and (o), of this subsection, be liable on indictment to imprisonment for a term of five years, or on summary conviction to imprisonment for a term of twelve months, and in the case of any other offence he shall be liable on conviction on indictment to imprisonment for a term of two years, or on summary conviction to imprisonment for a term of twelve months:

Provided that it shall be a good defence to a charge under any of paragraphs (a), (b), (c), (d), (f), (m), (n) and (o), if the accused proves that he had no intent to defraud, and to charge under any of paragraphs (h), (i) and (j), if he proves that he had no intent to conceal the state of affairs of the company or to defeat the law.

(2) Where any person pawns, pledges or disposes of any property in circumstances which amount to an offence under subsection (1)(o), every person who takes in pawn or pledge or otherwise receives the property knowing it to be pawned, pledged or disposed of in such circumstances as aforesaid shall be liable to be punished in the same way as if he had committed an offence under subsection (1)(o).

(3) For the purpose of this section "officer" shall include any person in accordance with whose directions or instructions the directors of a company have been accustomed to act.

2.4 Falsification of company's books[5]

If any officer or contributory of any company being wound up destroys, mutilates, alters or falsifies any books, papers or securities, or makes or is privy to the making of any false or fraudulent entry in any register, book of account or document belonging to the company with intent to defraud or deceive any person, he shall be liable on conviction on indictment to imprisonment for a period of five years.

2.5 General fiduciary duties owed to the company

(a) The common law as to general fiduciary duties has been codified in broad general terms under section 97 (1) (a) of the Companies Act 1981 which provides, "Every officer of the company in exercising his powers and discharging his duties shall … act honestly and in good faith with a view to the best interests of the company." This provision does not replace the common law as to directors' fiduciary duties. Bermudian and English

[5] Section 244 Companies Act 1981

common law authorities are considered by the Bermuda Court when dealing with cases involving directors' fiduciary duties.

(b) It is an established rule that insofar as a director of a company is bound by fiduciary duties , those duties are owed to the company only. A number of general legal rules stem from the broad statement of principle set out in section 97 (1) (a) of the Companies Act. These rules vary greatly in the range of application and at many points overlap with each other. The duties include:

(i) the duty to act bona fide in the interests of the company;

(ii) the duty to act for proper purposes;

(iii) the duties as trustee of company property which is in the hands or control of directors;

(iv) the duty to avoid a conflict of interest and duty;

(v) the duty to disclose interests in contracts at general law;

(vi) the duty not to make secret profits.

Once the company is insolvent, however, the interests of the creditors override those of the shareholders in the company. Thereafter the directors' duties are subject to an overriding duty to have regard to the interests of the general creditors of the insolvent company.

(vii) Section 97 (5A) of the Companies Act provides that an officer shall not be liable for a breach of duty of fiduciary duty under section 97 (1) (b) of the Companies act if he relies in good faith upon:

(a) financial statements of the company represented to him by another officer of the company; or

(b) a report of an attorney, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him.

(b) (i) Liability for breach of these duties is civil.

(ii) Liability is for all loss to the company occasioned by the breach of duty subject to the usual rules of recoverability based on considerations of causation and remoteness of damage.

(iii) An officer may be jointly and severally liable only if it is established that he "knowingly engaged in fraud or dishonesty."[6] In cases where fraud or dishonesty is not proved against the officer, but he is found liable, the Court determines the proportionate liability of each defendant and each of the other persons alleged to have caused or

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[6] Section 98B (2) Companies Act 1981

contributed to the plaintiff's loss[7]. The officer shall only be liable for his proportionate share of liability. He shall not be liable to the plaintiff for any judgment entered against other parties or to other parties for judgments entered against them[8].

(iv) Subject to Statute of Limitation considerations there is no time limit within which action may be taken against a director.

(v) Section 98 of the Companies Act permits companies to exonerate directors and to indemnify them either by contract or company by-laws. However, any contract or by-law provision that purports to exonerate or indemnify directors' in respect of fraudulent or dishonest conduct shall be void. Bermuda company by-laws typically contain some form of exoneration and indemnity provision for directors.

(vi) The Court has discretion to relieve the director either wholly or partly from liability on such terms as it thinks fit if:

(i) he acted honestly;

(ii) he acted reasonably; and

(iii) he ought fairly to be excused from liability in all the circumstances[9]

2.6 Duties of skill and care

(a) Similar to fiduciary duties, the common law as to duties of skill and care has been codified in broad general terms under section 97 (1) (b) of the Companies Act 1981 which provides, "Every officer of the company in exercising his powers and discharging his duties shall … exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." Bermudian and English common law authorities are considered by the Bermuda Court when dealing with cases involving directors' duties of skill and care.

As with fiduciary duties, a director's common law duties are subject to an overriding duty to have regard to the interests of the company's general creditors once it becomes insolvent.

(b) (i) Liability for breach of these duties is civil.

(ii) Subject to paragraph (iii) below, the court will award damages to compensate the company for loss that has been suffered as a result of the director's breach of duty[10].

(iii) An officer may be jointly and severally liable only if it is established that

7 Section 98B (3) Companies Act 1981

8 Section 98B (4) and (5) Companies Act 1981

9 Section 281 Companies Act 1981

10 In *West Mercia Safetyest v Dodd* [1988] BCLC 250 the court of appeal upheld a judgment ordering a misfeasant director to repay the value of a transfer by way of fraudulent preference.
In this case, the court effectively provided a "clawback" to recover the value of the amount wrongfully transferred.

he “knowingly engaged in fraud or dishonesty.”[11] In cases where fraud or dishonesty is not proved against the officer, but he is found liable, the Court determines the proportionate liability of each defendant and each of the other persons alleged to have caused or contributed to the plaintiff’s loss[12]. The officer shall only be liable for his proportionate share of liability. He shall not be liable to the plaintiff for any judgment entered against other parties or to other parties for judgments entered against them[13].

(iv) Subject to Statute of Limitation considerations there is no time limit within which action may be taken against a director.

(v) Section 98 of the Companies Act permits companies to exonerate directors and to indemnify them either by contract or company by-laws. However, any contract or by-law provision that purports to exonerate or indemnify directors’ in respect of fraudulent or dishonest conduct shall be void. Bermuda company by-laws typically contain some form of exoneration and indemnity provision for directors.

(vi) The court has discretion to relieve the director either wholly or partly from liability on such terms as it thinks fit if:

(i) he acted honestly;

(ii) he acted reasonably; and

(iii) he ought fairly to be excused from liability in all the circumstances.

2.7 Standard of fiduciary and common law duties owed by executive and non-executive directors

2.7.1 In applying the standards required by the foregoing fiduciary and common law duties, no distinction is drawn between the position of an executive and a non-executive director. However, the reference in the test set out in paragraph 2.13(a)(i) to “a reasonably prudent person in similar circumstances” does allow the Court to take into account such matters as, for example, the fact that a non-executive director’s functions are discharged on a part-time basis.[14]

2.7.2 In the absence of an employment contract the non-executive director will clearly not owe any contractual duties of care to the company. It is accepted that the non-executive director may rely on his co-directors to carry out various tasks and functions. This does not, however, abrogate his responsibility to inform himself about the company’s affairs and to join with his co-directors in supervising and controlling them. The non-executive may rely on a co-director to the extent that any matter lies within the co-director’s sphere of responsibility given the way the business of the company is organised and there exist no reasons for supposing that this reliance is misplaced.

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11 Section 98B(2) Companies Act 1981

12 Section 98B(3) Companies Act 1981

13 Section 98B(4) Companies Act 1981

14 *Focus Insurance Company Limited v Hardy et al Focus Insurance Company Limited v Hardy and Others* 1992 Civil Appeal No. 15 where the Bermuda Court of Appeal applied the test of directors’ duties of skill and care established in the English case *Re City Equitable Fire Insurance Company Limited* [1925] 1 Ch 407 in considering the standard of care imposed by section 97 (1) (a) of the Companies Act 1981.

2.7.3 Section 97 (5A) of the Companies Act provides that an officer shall not be liable for a breach of duty of skill and care under section 97 (1) (a) of the Companies act if he relies in good faith upon:

(a) financial statements of the company represented to him by another officer of the company; or

(b) a report of an attorney, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him.

2.8 Incurring further credit

2.8.1 The incurring of further credit may be the factual matrix for one of the grounds of liability discussed above, for example (and most probably) fraudulent trading. For further discussion please see answer to Question 11 below.

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Introduction

3. De facto and directors

3.1 At both common law and under statute, Bermuda law has widened the scope of those who may be regarded as directors or treated in the same way as directors. In particular, the common law has developed the concept of "de facto" directors - directors who, notwithstanding that they may not have technically been properly appointed as directors as a matter of company law are, as a result of their actions and the functions they carry out, treated as directors.

De facto directors

3.2 A de facto director is one who acts as a director and is treated as such by the rest of the board even though he may never have been formally appointed a director or there is a defect in the technicalities of his appointment (for example he was appointed at a meeting at which a quorum was not present). “Director” is defined in section 5.2(1) of the Companies Act 1981 to include any person occupying the position of director, by whatever name called. Thus, if someone were to be called an “observer” on the board but in fact took director-type decisions, then the court may be prepared to conclude that that person is a de facto director.

3.2.1 De facto directors owe the same duties to the company as directors who have been formally appointed. However, they may be further liable if they dispose of company property because they are wrongdoers. Unless the shareholders in general meeting resolve to ratify the disposals, they are liable to compensate the company for the value of the assets wrongfully disposed of. This right of action vests in the company.

3.2.2 De facto directors are able to bind the company in making contracts with third parties acting in good faith. They are not personally liable under those contracts under principles of agency law, but may be liable in damages for breach of an implied warranty of authority if they can be deemed to have warranted that they had authority to act on behalf of the company when no such authority existed.

3.2.3 Liability of auditor or officer[15]

(i) Where an auditor or an officer is found liable to any person for damages arising out of the performance of any function as such auditor or officer as contemplated by this Act, then the following provisions of this section shall apply.

(ii) An auditor or officer may be liable jointly and severally only if it is proved that he knowingly engaged in fraud or dishonesty.

(iii) In any case other than that contemplated by subsection (ii hereof, the liability of the auditor or officer, as the case may be, shall be determined as follows—

(a) the Court shall determine the percentage of responsibility of the plaintiff, of each of the defendants, and of each of the other persons alleged by the parties to have caused or contributed to the loss of the plaintiff. In considering the percentages of responsibility, the Court shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between the conduct and the loss claimed by the plaintiff;

[15] Section 98B Companies Act 1981

(b) the liability of the auditor or officer, as the case may be, shall be equal to the total loss suffered by the plaintiff multiplied by the auditor's or officer's, as the case may be, percentage of responsibility as determined under paragraph (a) hereof.

3.3 Other third parties who may be held liable

3.3.1 Liquidators may be found liable for misfeasance or breach of duty owed to the company[16].

3.3.2 Third parties who receive property as a result of a preference or transaction at an undervalue will be liable to either return such property or provide such compensation as the court may order. In addition, where a company is being wound up by the court, any disposal of the company's property made without the court's approval after the winding up order has been made will be void.

3.3.3 It is also possible for any third party who has dishonestly assisted in a breach of duty by a director or other officer of a company or knowingly received property arising from such breach to be liable in respect of any loss arising[17]. The legal rules relating to knowing assistance and/or receipt of property are applicable in any circumstance and not only in respect of actions taken during the twilight period. The power of the Bermuda court to apply these rules arises under its general equitable jurisdiction.

QUESTION 4

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4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

which is in financial difficulty and the inequality of bargaining power that may have arisen.

4. Summary of heads of challenge

4.1 The potential heads of challenge which may lead to transactions being set aside relate to transactions:

(a) which are at an undervalue;

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[16] For example, a party to "fraudulent trading" (for explanation of this concept see paragraph 2.2 above).

[17] Section 36A Conveyancing Act 1993

(b) which are preferences;

(c) comprising floating charges given for past value;

(d) in breach of the directors' fiduciary duties;

or which involve the following elements:

(e) onerous property;

(f) dispositions of the company's property made after the commencement of winding-up;

We look briefly at each head in turn.

4.2 Transactions at an undervalue[18]

Within certain limits, a disposition of property

(a) made with the dominant intention of putting property beyond the reach of a person (or class of persons) who has a claim or may at some time have a claim against the transferor; and

(b) without adequate consideration is voidable at the instance of certain eligible creditors. This rule applies within or outside liquidation (and in fact a liquidator appears not to have standing in relation to this particular jurisdiction). Insolvency is not a prerequisite. A creditor will be an eligible creditor if it falls into one of the following categories: (a) person to whom on, or within two years after, the date of the transfer the transferor owed an obligation which obligation remains unsatisfied on the date of the action or proceeding; and (b) a person to whom, on the date the contingency has fallen in, with the liability remaining unsatisfied; or (c) a person to whom the transferor owed an obligation in consequence of a claim that he made against the transferor, where the cause of action giving rise to the claim occurred prior to, or within two years of, the transfer. See part IV A of the Conveyancing Act, 1983.

4.3 Preferences[19]

4.3.1 By way of overview, a preference is something which a company does, at a time when it is insolvent and it later goes into liquidation, to put a creditor in a better position than he would have been if the company had instead just gone into liquidation. The attack is made by a liquidator and, the court has a range of options to restore the position.

[18] Section 237 Companies Act 1981.

[19] Section 239 Companies Act 1981

What is a preference?

4.4.2 Section 237(1) of the Act:

"Any conveyance, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against a company within six months before the commencement of its winding-up which, had it been made or done by or against an individual within the six months before the presentation of a bankruptcy petition on which he is adjudged bankrupt, would be deemed in his bankruptcy a fraudulent preference, shall in the event of the company being wound up be deemed a fraudulent preference of its creditors and be invalid accordingly.

The four conditions under this section are as follows:

(1) The company must have been unable to pay its debts as they became due at the time that the transfer is made.

(2) The transaction must have been in favour of a creditor or some person on trust for a creditor.

(3) There must have been an intention to prefer a creditor, or a surety or guarantor for the debt due to creditor, a preference over its other creditors.

(4) The disposition complained of must be made within six months of the commencement of the winding up.

Although the term fraudulent is used in the section, fraud in the strict common law sense need not be proved, although it may be present.

The onus will remain on those claiming to avoid the transaction to satisfy the court that the real intention was to prefer. In terms of proof it is enough that the liquidator proves facts which show that the intent to prefer is the most probable of the possible explanations.

Defences

4.4.3 The court shall not make an order under this provision in respect of a preference given to any person unless the company which gave the preference was influenced in deciding to give it by a desire to have the effect of giving a preference to that person. This is a question of fact - board minutes prepared when the relevant transaction was taken will be a starting point in this respect.

4.5 Avoidance of floating charges for past value[20]

4.5.1 This provision, which is in addition to the law of preferences (above), is specifically aimed at preventing creditors obtaining floating charge security for past debts in certain circumstances. It is not designed to impugn security given for new credit.

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[20] Section 240 Companies Act 1981

Conditions for setting aside

4.5.2 A floating charge is void under this provision if the following conditions are satisfied:

(1) the company is in liquidation ; and

(2) the floating charge was created within 12 months preceding the commencement of the liquidation.

(3) the charge was given otherwise than for cash (see below); and

(4) the company was then unable to pay its debts or became unable to do so in consequence of the charge.

4.5.3 The cash must be for the charge and it must go to the company itself or in the reduction of the company's indebtedness.

Defences

4.5.4 There are no specific statutory defences available but, as discussed above, the charge will not be invalid to the extent that cash value is provided.

4.6 Disclaimer of onerous property[21]

4.6.1 When the company is being wound up, the liquidator may, with leave of the Court disclaim any onerous property and may do so notwithstanding that he has taken possession of it, endeavoured to sell it, or otherwise exercised rights of ownership in respect of it.

4.6.2 Onerous property is not a defined term but generally would include (a) any unprofitable contract; and (b) any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.

4.6.3 Only an executory contract (where neither party has wholly performed its obligations) can be disclaimed but there can be no disclaimer of an executed contract (one which has been wholly performed by one party but not the other).

4.6.4 The disclaimer does not affect rights and liabilities already accrued. It determines, as from its date, the future rights interests and liabilities of the company in or in respect of the property disclaimed. The disclaimer does not (except so far as necessary for the purpose of releasing the company from any liability) affect the rights or liabilities of any other person. Any such person sustaining loss or damage as a consequence is deemed to be a creditor of the company to the extent of such loss or damage and may prove as such.

[21] Section 166 Companies Act 1981

4.7 Dispositions of the company's property made after the commencement of winding-up[22]

4.7.1 In a winding up by the court, any dispositions of the company's property, and any transfer of shares, or alteration in the status of the company's members, made after the commencement of the winding up is void.

4.7.2 Commencement of the winding up backdates to the date of presentation of the petition for compulsory winding-up if an order is ultimately made. The voidness applies unless the court otherwise orders - so a company or a counterparty may seek a court validation order in respect of transactions in this period, when perhaps it is unclear whether the company will be able to pay off the petitioning creditor

4.8 Registration of charges

4.8.1 Bermuda law operates a system of registration of security created over certain property by Bermuda companies Failure to register a charge does not render it ineffective against a Liquidator. Non-Registration of a charge will affect the priority of the charge but will not affect the validity of the charge against the company or a liquidator.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Introduction

In the event of a company going into liquidation, the authority and powers of the directors are generally superseded following such an appointment and taken over by the liquidator, The Liquidator is required to review the action taken by the directors and others during the twilight period and where relevant bring proceedings to obtain compensation for the benefit of creditors in respect of any loss caused to the company. Consequently, in most cases it is the Liquidator only who is empowered to bring actions against directors and others where there has been a breach of either the legal or fiduciary duties owed to the company. There are a few exceptions to this rule in respect of certain transactions/offences for which action may be brought by creditors or others directly. These are detailed in the table below.

5.1.2 However, where criminal proceedings are brought against directors or others in respect of some form of criminal action, such proceedings must be brought

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[22] See also Rules 43 and following of the Companies (Winding-Up) Rules 1982 and Rules 46 and following of the same.

by the Director of Public Prosecutions ("**DPP**") on behalf of the relevant government department or authority.

5.2 Criminal Proceedings

5.2.1 The following acts are criminal offences in respect of which the DPP may bring an action against the directors and others involved. The office holder (such as a liquidator) of a company is under a duty to bring any such offences to the attention of the DPP. Those who may be liable in respect of the following offences in addition to the directors are listed in question 3 above.

Offences

(a) Fraud in anticipation of winding-up - section 245 of Companies Act

(b) Misconduct in course of winding-up - section 243

(c) Falsification of company's books - section 244

(d) Fraudulent trading - section 246 of Companies Act

5.3 Civil Proceedings

5.3.1 In relation to civil proceedings, the ability to bring actions against directors and others is primarily held by the liquidator. However, in respect of certain actions which have caused loss to the company and its creditors, the law allows a wider range of persons to bring action to recover funds for the benefit of the company's creditors. Where an action for a contribution to the company's assets is successful, even if the person bringing the action is not the office-holder, any recoveries made will be for the benefit of all creditors of the company and will be distributed amongst the creditors in accordance with the normal rules relating to priority.

5.3.2 The table below sets out those people who may bring an action against the directors and others in connection with certain transactions which the company has entered into.

Activity/transaction	Person able to bring proceedings
Misfeasance	Liquidator, Official Receiver, a creditor or, with leave of the court, a contributory
Fraudulent trading	Liquidator, Official receiver, a creditor or a contributory.
Transaction at undervalue	An Eligible Creditor. There is doubt whether a Liquidator has standing.
Fraudulent Preference	Liquidator

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

Offence	Remedy Available
Fraudulent Trading	The penalty is up to two years imprisonment and/or a fine of two thousand five hundred dollars or both.
Fraudulent Trading	The director may be ordered to make such contribution to the company's assets as the court thinks fit. In exercising its discretion under this section the Court may include a punitive element as well as a compensatory element.
Fraud in anticipation of a winding up	If prosecuted on indictment the penalty is up to two years' imprisonment and, on summary conviction, a term of imprisonment of up to twelve months.
Falsification of Company Books	If tried by a jury the penalty is up to five years' imprisonment.
Misfeasance	This section provides a mechanism for summary trial and does not create any new category of liability. The Court may order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the Court sees fit **or** to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the Court sees fit.
Fiduciary Duties	The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.
Duties of skill and care	The director may be ordered to compensate the company for all loss and damage caused by breach of his fiduciary duty.

Offence	Remedy Available
Transactions at an undervalue and preferences	The court may make such order as it thinks fit in order to restore the position to that which would have existed if the company had not entered into the impugned transaction. It may, for example, order: (a) that any property transferred as part of the impugned transaction be re-vested in the company; (b) that any property which represents the application of either the proceeds of sale of the property or money wrongfully transferred be vested in the company; (c) the release or discharge of any security given by the company; (d) require any person to pay such sums as represent the value of any benefits received by him from the company in breach of sections 237 of the Companies Act 1981 and Section 36A of the Conveyancing Act 1993; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or in part) under the transaction, or by giving of the preference, to be under such new or revived obligations to that person as the court thinks appropriate; An order under these provisions cannot prejudice any interest acquired from a person other than the company which was acquired in good faith and for value. It cannot prejudice any interest deriving from such an interest. It must not require a person who received a benefit from the impugned transaction in good faith and for fair value to make payment except where that person was a party to the transaction with the company or was a creditor of the company at the time of the transaction.
Transactions defrauding creditors	The court may: (a) require that any property transferred as part of the transaction be vested in any person, either absolutely or for the benefit of all the persons on whose behalf the application for the order is treated as made;

Offence	Remedy Available
	(b) require any property to be vested in any person's hands which represents either the proceeds of sale of property or of money so transferred; (c) release or discharge (in whole or part) any security given by the debtor; (d) require any person to pay to any other person in respect of benefits received from the debtor such sums as the court may direct; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or part) under the transaction to be under such new or revived obligations as the court thinks appropriate; (f) provide for security to be provided for the discharge of any obligation imposed by or arising under the order for such an obligation to be charged on any property and for such security or charge to have the same priority as a security or charge released or discharged (in whole or in part) under the transaction. Any order made must not prejudice any interest in property acquired from a person other than the debtor which was acquired in good faith for value and without notice of the relevant circumstances. The court shall not require any person who derived a benefit from the impugned transaction in good faith without notice of the relevant circumstances, to pay any sum unless he was a party to the transaction.
Avoidance of a floating charge	The Court can declare that the floating charge is invalid in whole or in part.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations?

The following summarises the main statutory provisions which oblige directors and others to co-operate with an investigation into a company's affairs following its insolvency:

7.1 Statement of Affairs

7.1.1 Section 168(1) of the Companies Act 1981 requires that a detailed statement of the company's affairs in a prescribed form must be provided by one or more of the directors and its secretary. The section applies whenever a winding-up order has been made in respect of a company or a provisional liquidator has been appointed and, in either case, within 30 days of that event. The statement must be verified by affidavit and must include such things as particulars of the company's assets, liabilities, and details concerning the company's creditors.

7.1.2 The Official Receiver may stipulate that persons other than the directors (a promoter, an employee or an officer) must provide the statement. The court has the power to waive or vary the requirement. Rules 34 and following of the Companies (Winding-up) Rules 1982 stipulate additional provisions in relation to the statement of affairs including a provision enabling the Official Receiver to extend the time within which the statement is to be submitted.

7.1.3 A person who is required to but fails to comply with the requirement to provide a statement of affairs is liable to a default fine.

7.2 Delivery of the company's property

7.2.1 Section 186 of the Companies Act 1981 applies whenever a winding-up order has been made in respect of a company.

7.2.2 In such a case, where a person has any property, money, or books and papers to which the company is prima facie entitled, the court may require that person forthwith (or within such period as the court may direct) to pay, deliver, convey, surrender or transfer the property, books, papers or records to the liquidator. The section applies only to any contributory (generally a shareholder), trustee, receiver, banker, agent, or officer of the company.

7.2.3 Rule 54 of the Companies (winding-up) Rules 1982 provides that, unless the court orders otherwise, the powers of the court referred to above (under section 186) are to be exercised by the liquidator on behalf of and subject to the control of the court.

7.3 Power to Summon Persons

7.3.1 Section 195 of the Companies Act 1981 applies whenever a provisional liquidator has been appointed or a winding-up order has been made. In such a case, the court may summon to appear before it:

(a) any officer of the company;

(b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or

(c) any person whom the court deems capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.

7.3.2 Such a person may be required (a) to submit to an examination on oath concerning the matter referred to at 7.3.1(c) above and (b) to produce any books, papers or other records in his custody or power relating to the company.

7.3.3 If a person refuses to appear before the court when summoned the court may cause the person to be apprehended and brought before the court.

7.4 Public examination of officers

7.4.1 By virtue of section 196 of the Companies Act 1981,[23] where a winding-up order has been made, the Official Receiver may make a report stating his opinion that a stipulated person

(a) has been guilty of fraud or dishonesty;

(b) is in default of any provision of law pertaining to companies; or

(c) has shown himself to have acted in an improper, reckless or incompetent manner in relation to the company's affairs;

7.4.2 The section applies to (a) a person who has taken part in the promotion, or formation of the company (b) an officer of the company.

7.4.3 In such a case, the court may direct that the person attend before the court to be publicly examined as to his conduct in relation to the company. The Official Receiver must take part in the examination and (if the Official Receiver is not the liquidator) the liquidator may also take part in the examination.

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[23] See also section 244 of the Companies Act 1981 which creates the offence of, among other things, falsifying documents for the purpose of misleading any person.

7.4.4 Under section 197 of the Companies Act 1981, a contributory suspected of (among other things) intending to abscond or to conceal property or avoiding examination may be arrested and his books and papers and other personal property seized.

7.5 Creditors' Voluntary Cases

7.5.1 Section 231 of the Companies Act 1981 enables the court to exercise any power which the court may exercise if the company were being wound-up by the court. This means that all of the court's powers referred to above in the event of a winding-up order being made may also be exercised where the company is being wound up under the creditors' voluntary procedure.

7.6 Enforcement – Sanction for failing to discover to the liquidator the company's property and papers when it is being wound up

7.6.1 Section 243 of the Companies Act 1981[24] stipulates that on any person, being a past or present officer of the company which is being wound up (by order or voluntarily), commits an offence if he (amongst other things):

(a) fails to discover to the liquidator all the company's property and how any of it may have been disposed of (if other than in the ordinary course of business); or

(b) fails to deliver up to the liquidator all property or books and papers belonging to the company which are in his custody or control; or

(c) fails to inform the liquidator of any false debt which he believes has been proved by any person in the winding up; or

(d) after the commencement of the winding-up prevents production of books and papers relating to the company's property or affairs.

7.7 Human Rights

7.1.1 No human rights laws are applicable in relation to any of the obligations referred to above. The constitution of Bermuda[25] does protect certain civil rights but none appears to have any bearing on the discussion in this part.

QUESTION 8

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8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

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[24] United Kingdom Statutory Instrument SI 1968 No. 182, Bermuda Constitution Order 1968.
[25] Section 278 of the Companies Act 1981.

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

Limitation Period for Criminal Proceedings

8.1.1 No limitation period applies to the criminal offences created by virtue of those provisions of the Companies Act 1981 referred to in question 2 which are indictable offences. In the case of those identified in the Companies Act 1981 as summary offences, the limitation period is 3 years from the time when the offence is committed.[26]

Limitation Period for Cause of Action for Sum Recoverable by Statute

8.1.2 The Companies Act 1981 does not stipulate limitations periods in connection with the statutory doctrines referred to in question 2. Therefore the applicable limitations period in respect of any provision enabling the recovery of a sum of money is applicable. That limitation period is 20 years from the date the cause of action accrued.[27]

Limitation Period for Civil Actions in misfeasance, tort or contract

8.1.3 In relation to breaches of the director's fiduciary duties or for any common law duties in tort, or breach of contract, the limitation period is generally 6 years from the date on which the cause of action accrued[28]. Where the cause of action is based on fraud or for the relief of any mistake, or any relevant act has been deliberately concealed by the defendant, the limitations period does not begin to run until the plaintiff discovers the fraud, mistake or concealment[29].

8.2 Appeals

8.2.1 Except in relation to interlocutory matters or orders for costs, an appeal may be made from any decision of the Supreme Court of Bermuda, being the lower court in relation to proceedings of the type described in question 2[30].

8.2.2 Appeals from decisions of the Court of Appeal to the UK Privy Council, being the highest court of appeal for Bermuda, are permitted as a matter of right from final decisions of the Court of Appeal where the sum at stake is in excess of $12,000 or in any case (final or interlocutory) where the Court of Appeal considers that the appeal should be heard by reason of its "great general of public importance or otherwise."[31]

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[26] Section 11 of the Limitation Act 1984.
[27] Section 4 and section 7 of the Limitation Act 1984
[28] Section 33 of the Limitation Act 1984.
[29] Section 12 of the Court of Appeal Act 1964.
[30] Section 2, Appeals Act 1911.
[31] Section 4(1) and section 4((1A) of the Companies Act 1981

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Introduction

9.1.1 Most of the doctrines outlined above at question 2 may be invoked by a liquidator of a company subject to winding-up proceedings. Therefore the application of these doctrines to a foreign company will generally depend upon the extent to which a foreign company may be wound up under the law of Bermuda. That topic is addressed below at 9.2.

9.2 Jurisdiction of Bermuda courts

9.2.1 The provisions of the Companies Act 1981 pertaining to insolvent liquidation generally apply to the following:

(a) companies incorporated in Bermuda under the Companies Act 1981 and its predecessor legislation;

(b) overseas companies which are authorised to carry on business in Bermuda.[32]

9.2.2 There is one judicial precedent supporting the proposition that the provisions pertaining to insolvent liquidation may also apply to an overseas company which carries on business in Bermuda illegally (i.e. without a permit).

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 It is permissible for a director to take out insurance pursuant to Section 98A and the company may lawfully pay the premiums.
Section 98A – Insurance of officers

[32] Informission Group Inc. v. Convertix Corporation, Supreme Court of Bermuda, Civil Jurisdiction 1999 No 267, December 6, 2000 (Wade J.). The application was made ex parte and may or not be followed in subsequent cases.

A company may purchase and maintain insurance for the benefit of any officer of the company against any liability incurred by him under section 97(1)(b) in his capacity as an officer of the company or indemnifying such an officer in respect of any loss arising or liability attaching to him by virtue of any rule of law in respect of any negligence, default, breach of duty or breach of trust of which the officer may be guilty in relation to the company or any subsidiary thereof and nothing in this Act shall make void or voidable any such policy.

10.2 The insurance policy cannot enable the director to insure against his own willful or fraudulent wrongdoing as it will be struck down on grounds of public policy in this regard.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 Overview

11.1.1 The details of directors' duties are considered above at question 2. Directors, when their company is insolvent or is likely to become insolvent, must put the interests of the creditors of their company before those of the shareholders.

11.1.2 Bermuda law therefore seeks balance the need to prevent directors continuing to operate companies when it is clear that creditors will not get paid and, on the other hand, not putting undue pressure on directors to cease trading when the undertaking is still feasible and merely going through a difficult time.

11.1.3 Directors should get independent professional help on the legal and accounting sides to bolster any decision they make to continue in business. They should monitor closely the financial position of the company. Directors can prepare a reasoned plan of recovery with their accountants and seek the support of their main creditors (often banks and major suppliers). Lawyers will usually assist in ensuring that board meetings are held regularly to consider responsibly and objectively the company's position and its prospects and document these in the minutes of the meetings to ensure that a "reasonable" view is taken of the prospects of recovery.

11.2 Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period?

11.2.1 The risk of dealing with a company which is or may become insolvent is that most legal systems, and Bermuda law is no exception, have a vulnerability period reaching back from the moment the formal insolvency procedure commences. In Bermuda, the main periods are six months for preferences and two years for transactions at undervalue. Other heads of attack have no such time limit, for example, fraudulent trading - or cases where directors have been acting in breach of duty and this is something of which a counterparty dealing with the company is fully aware. We look at the two main statutory clawback provisions.

11.3 Preferences

11.3.1 The law here is concerned with the clawback of payments and the over-turning of security.

11.3.2 From a prospective of a creditor doing business with a company the position is likely to be that they should enter into a transaction to accept payment or the grant of security and wait and see what happens. There have been no successful claims of fraudulent preference in Bermuda since its introduction. A liquidator will not to show the intention of the Company and except in exceptional circumstances the transactions are in the usual course of business and necessary to allow the company to continue its business.

11.4 Transactions at an undervalue

It is only Eligible Creditors who can attack such a transaction. Insolvency of the Company entering into the transaction is not a prerequisite to an offence being committed. A Creditor could attempt to make inquiries into the circumstances of the transferor however these are strictly protections to a transferee. The protections include if a transaction is reversed that costs of the transferee can be reserved in full and the transferee has a security interest in the asset to the extent of the claim. The burden is on the Eligible Creditor to show that the transferee did not act in good faith.

APPENDIX

Summary of primary Bermuda insolvency procedures

(i) LIQUIDATION PROCEDURES

Three separate liquidation procedures are available. These are:

- Voluntary winding-up;
- Winding-up under the supervision of the court (also known as compulsory winding-up);
- The implementation of a scheme of arrangement under section 99 of the Companies Act, 1981.

As well as being available as a separate procedure, the scheme of arrangement may also be used in combination with one of the two winding-up procedures.

Each of these procedures is described below.

(A) VOLUNTARY WINDING-UP

A members voluntary winding up is the usual procedure used to liquidate a solvent company. It should be distinguished from a creditors voluntary winding up which is appropriate only when a company is insolvent. The phrase voluntary winding up in this discussion paper refers to a members voluntary liquidation.

A majority of the directors of the company must swear declarations of solvency. These declarations state that the directors have made full inquiry into the affairs of the company and believe that the company will be able to pay its debts in full within a period of twelve months from the date of the declaration. An up-to-date balance sheet is attached to the declaration which shows all assets and liabilities (actual, future and contingent).

Usually a board meeting is held and the directors review the declarations and resolve to recommend to the shareholders to vote in favour of a voluntary winding up and authorise the secretary to file the declarations of solvency with the Registrar of Companies in Bermuda. The directors call a special general meeting of the shareholders. At that meeting the shareholders pass a resolution in favour of the voluntary winding up and appoint a liquidator.

The liquidator advises the Registrar of Companies of his appointment and places advertisements in the local press inviting creditors to file their claims and notice of the resolution to wind up and the appointment of the liquidator.

Following the appointment of the liquidator the powers of the directors cease, except so far as the shareholder in general meeting of the liquidator sanctions the continuance of those powers.

Similarly, after the shareholders pass the resolution to wind up the business of the company must cease, except as far as may be required for the beneficial winding up of the company.

If at any time the liquidator is of the opinion that the company will not be able to pay its debts within the twelve-month period mentioned in the declarations of solvency he must call a meeting of creditors and advise them of the position.

The liquidator will take steps to collect in all of the assets of the company and after payment of all liabilities will distribute assets to the shareholders. If the by-laws of a company contain provisions governing the distribution of the surplus assets the liquidator must have regard to these provisions.

After all assets are collected and liabilities settled and surplus assets distributed the liquidator will call a final general meeting of the shareholders. The shareholders will approve the statement of account of the liquidator and pass a resolution to dissolve the company.

There is no automatic stay of proceedings in a voluntary winding up. The liquidator is able to apply to the Supreme Court for directions on any matter. The rules governing proofs of debt and the valuation of claims within a liquidation apply in a voluntary winding up.

B. WINDING-UP BY THE COURT

A winding-up by the court commences following the filing with the court of a petition presented by the company, its directors, one or more creditors or contributories, a combination of these or the Registrar of Companies. The court has jurisdiction to grant a winding-up order on a number of separate grounds including:-

(a) that the company has resolved that the company shall be wound-up by the court;

(b) that the company is unable to pay its debts, taking into account contingent and prospective liabilities; and

(c) that the court is of the opinion that it is just and equitable that the company be wound-up.

Where the winding-up procedure is commenced at the instance of the directors, the simplest procedure is to call a meeting of the shareholders for the purposes of resolving that the company be wound-up by the court. An affidavit may then be filed in support of the petition attaching a copy of the resolution of the shareholders and, where applicable, providing financial information demonstrating that the company is unable to pay its debts (taking into account contingent and prospective liabilities).

Upon the presentation of a winding-up petition, a court may immediately appoint a provisional liquidator who may be the Official Receiver or any other fit person. There are no licensing requirements or prescribed qualifications for liquidators, although the practice is to appoint chartered accountants specialising in insolvency. The powers of a provisional liquidator are determined by reference to the order appointing him.

Upon the granting of a winding-up order, the provisional liquidator must summon separate meetings of the creditors and contributories of the company for the purpose of determining:-

(a) whether an application should be made for an order appointing a permanent liquidator (or joint liquidators); and

(b) as a practical matter, the identity of a person or persons they wish to be appointed.

An application may then be made for an order giving effect to the wishes of the creditors and contributories. If the wishes of the creditors appear inconsistent with those of the contributories, the court must resolve the difference (normally in favour of the creditors).

All of the necessary steps in relation to a compulsory liquidation can be accomplished quite quickly, as follows:-

(a) A resolution of the shareholders can be passed as soon as the meeting may be convened.

(b) The petition for the winding-up of a company may be prepared and filed within a matter of days after the passing of a resolution of the shareholders.

(c) An application for an order appointing a provisional liquidator (if necessary) may be made as early as the same day as the filing of the petition.

(d) An application for a winding-up order would normally take place as early as three or four weeks after the filing of the petition.

(e) The meetings of the creditors and contributories are normally held within four to six weeks from the granting of the winding-up order.

(f) An order appointing a permanent liquidator (or joint liquidators) would normally be made within about 2 weeks from the holding of the meetings.

It is noteworthy that, once the winding-up order has been made or a provisional liquidator has been appointed, an automatic statutory stay of proceedings comes into force with the result that no proceedings may be commenced or continued against the company except with the leave of the court.

SCHEME OF ARRANGEMENT

A scheme of arrangement ("a scheme") is a statutory arrangement (effectively a contract) between a company and its creditors (or any class of them). The scheme becomes legally binding on all creditors to whom it is intended to apply, if:-

(a) a majority in number representing three-fourths in value of all those in the affected class vote in favour of the scheme at a meeting of creditors convened by the court; and

(b) the court then approves the scheme.

As mentioned earlier, a scheme may be implemented either within the liquidation context or as a alternative to liquidation.

This part will summarise the procedure for implementing a scheme and review some of the advantages of implementing a scheme in the insurance context.

(a) Procedure

Where a scheme of arrangement is proposed, the company, or its liquidator, must apply to the court for an order convening a meeting of the creditors (or class of creditors) to be bound by the scheme. The first step, therefore, is to make application for an order convening a meeting of creditors. The meeting is then convened in the usual way. In order for the scheme to become effective and binding, a resolution to approve it must be passed by a majority in number representing three-fourths in value of the creditors (or class of creditors) present and voting either in person or by proxy at the meeting. If the statutory majority is obtained, the scheme then has to be sanctioned by the court. Once an order approving the scheme has been obtained, a copy of the order must be submitted to the Registrar of Companies for registration, whereupon the scheme becomes effective.

(b) Advantages of a Scheme

Without a scheme, the affairs of an insurance company in liquidation in Bermuda must be administered in accordance with the statutory regime governing company liquidation, and this regime is not well-suited to insurance. The statutory framework entails the appointment of a liquidator who must conduct "just estimates" of contingent and unliquidated claims, and must permit creditors to file new claims (and revise existing claims) at any time prior to the final distribution of any significant dividends until all claims are fully ascertained (that is, until all reserves for incurred but not reported claims evolve into liquidated claims). If he is prepared to pay dividends prior to the development of pro-rata basis to creditors based on his "just estimates" of those claims.

The primary advantage of a scheme is that it can in effect establish a new regime, overriding many of the practical and legal restrictions which otherwise apply in an insurance liquidation. Under a scheme, the administrator is not dealing with constantly "moving targets" and has assurances under the scheme that, provided he acts responsibly and in accordance with the scheme, he will not be as exposed to criticism as a liquidator would be if, for example, he underestimates the reserves.

A scheme may be used to enable the administrator to pay distributions on claims as and when they develop and to hold back reserves to deal with contingent and unliquidated claims as those develop. This type of scheme is sometimes referred to as a “reserving scheme”, which is now the most common type used in the context of insurance liquidation. An alternative form is a “cut-off” or “valuation” scheme which may provide for a binding final claims filing deadline enabling a final evaluation of claims, a distribution of assets based on those estimates and provisions preserving the rights of the company against reinsurers. This type has the advantage of dramatically shortening the liquidation.

BRAZIL

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 On a company being declared bankrupt in Brazil, the judge establishs the date on which the insolvency period will be deemed to have commenced[1] .

1.1.2 The insolvency period commencement date is to be counted from either the first protest for lack of payment, the ruling of the initial bankruptcy petition[2] or the filing of the request for preventive concordata (a legal moratorium on the payment of unsecured claims). The insolvency period may be further extended by 60 days, retroactively. The insolvency period is also called the "suspect period".

1.1.3 A new Brazilian Bankruptcy Law is under discussion in the Brazilian Congress and should be approved before the end of 2004. With regard to the Twilight Period, the proposed New Bankruptcy Law extends the allowable retroactive suspect period to ninety days from the commencement date.

1.1.4 There is no special liability system during the Twilight Period. The only provision specifically relating to officer and director liability in the Bankruptcy Law deals exclusively with procedural requirements, establishing that the personal liability of an officer or director of a bankrupt company shall be adjudicated in a separate action brought before the competent bankruptcy court which is administering the company's bankruptcy.

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:

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1 Article 14 of Decree Law 7,661/45, "the Bankruptcy Law". Following references are to this act unless another law is specified

2 Articles 8 and 12

(i) is any resulting liability against a director civil, criminal or both?

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what differences, if any, will be available in relation to each offense?

2.1 Brazilian legislation does not provide for a specific liability system during the Twilight Period. Corporate officers and directors may be personally liable when[3]:

(a) within the scope of their powers, they act recklessly, negligently, incompetently or fraudulently; or

(b) they violate the law or perform ultra *vires acts*, whether or not they do so in a negligent or fraudulent manner.

Should an entity exist solely for the purpose of shielding principals/shareholders from liability, the principle of "piercing the corporate veil" may be applicable. This concept is also known as "disregarding of the legal entity". As in other countries, the legal principle of piercing the corporate veil in Brazil disregards the corporate fiction in order to avoid an injury to the public. Pursuant to this principle, the principals/shareholders would be liable as if there were no corporate entity and these principals/shareholders would be considered personally liable for the debts which are owed by the corporate entity.
The potential liability would be direct and applicable jointly, severally and without limit.

In Brazil, piercing of the corporate veil has occurred for the irregular dissolutions of entities; improper intermingling of corporate assets involving a sole shareholder or administrator; implementing activities which are incongruent with the corporate purposes; and the absolute power of one partner who is involved with fraudulent acts.

Additional rules impose joint, several and personal liability on corporate directors for illegal acts as opposed to liability arising from a failure to carry out duties and obligations in connection with the regular functioning of the company[4].

A director is not responsible for the illegal acts of other directors, unless he knowingly conspires with them or is found negligent in efforts to discover their illegal acts, or having knowledge of the wrongdoing, fails to attempt to impede such acts. On the other hand, directors are jointly and severally liable for

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3 Articles 1,015; 1,016 and 1,017 of Law 10,406/2002 (Civil Code) and Article 158 of Law 6,404/76 (Corporation Law)

4 Corporation Law (Article 158, Sections 1-5)

damages resulting from a failure to carry out their duties and obligations in connection with the regular functioning of the company, even if each director is not responsible for the performance of all the duties.

The failure to produce and publish annual balance sheets, which in turn may impair the regular functioning of the company, may result in the joint and several liability of directors. In any event, a director who learns of a failure on the part of a current or former director to perform his corporate duties must communicate this fact to the shareholders at a general meeting in order to exonerate himself from liability for damages caused as a result of the current or former director's failure to act.

With regard to management duties, both the courts and legal scholars have established the general rule that negative facts, resulting from acts of omission or failure to act, even if not the result of joint deliberation, will result in the joint and several liability of the administrators. However, the existence of positive facts resulting from the intentional acts of an individual manager will limit such liability to the offending manager. Either negative or positive facts resulting from joint deliberations can give rise to joint and several liability, except for those individuals who expressly objected.

For publicly traded companies, directors will only be liable for damages resulting from a failure to perform their duties in accordance with the company by-laws. The Brazilian Securities and Exchange Commission ("*Comissão de Valores Mobiliários*" - CVM) can impose administrative penalties by means of administrative hearings including warnings, fines and the suspension or disqualification of directors. The Brazilian Central Bank has similar authority to issue warnings and to impose fines, suspensions and disqualifications with respect to the directors of financial institutions.

Upon declaration of bankruptcy, the court will require that the entity undergo a judicial examination to determine whether there are facts and circumstances that warrant bringing criminal charges against it. The trustee shall furnish an investigative report specifying any alleged criminal offences by the debtor, and, if appropriate, request that charges be brought[5]. Creditors may petition for charges to be brought if the trustee does not do so[6]. Based on the evidence provided by the trustee or creditors, the District Attorney may initiate criminal charges.

The Bankruptcy Law states that a bankrupt corporation's directors and officers will be held accountable for the following criminal acts relating to a bankruptcy:

(a) the use of destructive means to obtain resources and to delay the declaration of bankruptcy, such as making sales at prices below the current market value during the six months prior to filing for bankruptcy;

(b) failure to keep required books, or their late, defective, or unclear completion;

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[5] Article 103
[6] Article 104

(c) fraudulent acts, committed prior or subsequent to the declaration of bankruptcy, for the purposes of obtaining an unfair advantage;

(d) accelerated payment of certain creditors to the detriment of other creditors;

(e) acknowledgment of false or misrepresented credits.

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Brazilian insolvency regulations do not provide for the direct civil liability of personnel and fiduciaries, such as lawyers, accountants and other professionals, who acted on behalf of the bankrupt entity. The bankrupt entity itself is considered liable for any damage caused by such third parties. However, the entity may file a recovery action against the personnel or fiduciaries that caused the damage. An attorney is personally liable for the acts that, in the exercise of the legal profession, are performed with deceitfulness or fault comprising malpractice, recklessness or negligence[7]. The lawyer shall be jointly liable, along with his client, if deceitful acts were performed by the attorney during the proceedings with the aim of causing damage to a third party.

Professionals such as lawyers, accountants and other fiduciaries may not be held liable for failing to attain successful results in their professional activity. However, they are required to employ all the expected efforts and to display the necessary due diligence and accuracy in their services.

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[7] Article 32 of Law 8,906/94

The Brazilian courts usually do not hold liable individuals who were not participating in the active management of the corporation at the time of a criminal occurrence. However, new managers who learn of the existence of former or continuing criminal acts, committed or initiated prior to their joining the company, must inform the shareholders in order to exonerate themselves from liability.

Under the Brazilian Penal Code, the criminal acts of corporate fiduciaries are punishable by imprisonment and/or fines. Such punishable acts include:

(a) making false representations, or intentionally hiding pertinent information, as to the financial status of the company in reports, balance sheets or in communications which are made to the public or to shareholders;

(b) promoting the false pricing of shares by means of deception;

(c) using corporate assets for the personal benefit or for the benefit of third parties without prior shareholder authorization; and

(d) obtaining the approval of minutes or opinions through collusion with the shareholders.

In addition to the Penal Code, various other laws specifically address the criminal liability of corporate fiduciaries. Law 1,521/51, concerning crimes against the economy, provides that fiduciaries may be found liable for committing crimes such as the falsification of registrations, reports or other data for the purpose of withholding profits, dividends or bonuses, or in order to misappropriate funds.

Any person, including the debtor, may be found criminally liable for hiding or diverting assets from the bankrupt estate or making false statements or claims within the proceedings[8]. The trustee is also liable for providing the judge or the parties with false information and for presenting reports in discordance with the truth. The judge, public attorney, trustee, expert, bailiff and auctioneer may be held liable for directly or indirectly purchasing assets from the estate, or entering into any profit-oriented speculation[9].

Lender’s liabilities are not yet an important factor in Brazil. Initial cases are being argued in courts, but generally financial institutions have been subject to the potential damage which such claims may cause. As a general rule, reckless lending does not give rise to a liability to indemnify other creditors. However, case law is still developing in this area.

[8] Article 189
[9] Article 190

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What difference, if any, to the areas of vulnerability identified above will be available to a counterparty seeking to protect a transaction from being attacked?

4.1 The adjudication of a merchant's bankruptcy does not include his guarantors, joint co-debtors or surety guarantors. Therefore, while the bankruptcy causes the acceleration of the maturity of the bankrupt party's debts and those of any joint shareholder of the bankrupt company, it does not automatically entail the bankruptcy of its solvent co-debtors and guarantors. Additionally, the termination of collateral agreements may be avoided in circumstances where the trustee considers the continuation of the agreement necessary and in the interest of the bankrupt estate.

4.2 Certain acts performed by the bankrupt party within the Twilight Period are considered non-existing, whether or not the other party to the act was aware of the impending bankruptcy and whether or not the transaction was performed with the intent to defraud. These acts are as follows:

(a) The payment of unmatured debts by the debtor within the Twilight Period, through any means to extinguish the credit, or by discounting the title itself;

(b) The payment of matured and payable debts within the Twilight Period, through any means which are not provided for in the agreement;

(c) The establishment of a security interest, including retention, within the Twilight Period, for a debt contracted before such period;

(d) The performance of non-onerous acts for up to two years before the declaration of bankruptcy;

(e) The waiver of an inheritance, for up to two years before the declaration of bankruptcy;

(f) The advance repayment of a dowry or its delivery before the time limit provided in a prenuptial agreement;

(g) The registration of mortgages or the transcription of property transfers *inter vivos*, at cost or free of charge, or the registration of real estate, performed after the decree of attachment or the declaration of bankruptcy, unless a prior pre-registration has taken place.

(h) The sale or transfer of a commercial or industrial facility without the express consent or payment of all the creditors, existing at the time, if the remaining assets are insufficient to settle the bankrupt party's liabilities. (This is applicable unless, within thirty days, no opposition has been voiced by the creditors to the sale or transfer of which they were notified. Such notice shall be made judicially or by the officer of the Registry Office of Titles and Documents).

4.3 Revocable Acts

4.3.1 Any acts performed in connection with the bankrupt estate with the intent to harm creditors are subject to revocation, provided that the debtor acted in collusion with the third party[10]. A specific action (revocatory action) should be pursued in order to revoke such fraudulent acts. Under Article 52, no intent to defraud is required and the acts are automatically deemed as null and void, whereas under Article 53 the intent to defraud and to harm creditors must be evidenced in a revocatory action.

The trustee must file for revocation when a fraudulent act has taken place[11]. If the trustee fails to do so within the term provided for in the law, the revocation may be filed by any creditor. Revocation actions may be filed:

(a) against all those who took part in the act, or as a consequence thereof, were paid, given guarantees or benefited;

(b) against the heirs or legatees of the persons mentioned above;

(c) against acquiring third parties if they were aware, at the time of the fraudulent act, of the bankrupt party's intent to harm its creditors;

(d) against acquiring third parties if their right was derived from an act mentioned in Article 52; and

(e) against the heirs or legatees of the persons mentioned in the preceding item.

It should be noted that an ordinary suit, if contested, can take two or three years to take to judgment, and such judgment may be subject to further appeal. An enforcement action also generally takes between two and three years in Brazil, depending on the facts of the case and the speed with which the debtor's assets can be identified for attachment.

In practice, the purchase of property from a party subject to a bankruptcy proceeding involves certain risks. The registration of mortgages or the transcription of property transfers *inter vivos*, at cost or free of charge, or the registration of real estate performed after the decree of attachment or the declaration of bankruptcy are ineffective, unless a prior pre-registration has taken place[12]. Also, for the purchase of a commercial or industrial facility to be effective, such purchase must have the consent of all creditors, should the remaining assets be insufficient to solve the debtor's liabilities (Article 52, viii).

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[10] Article 53
[11] Article 55
[12] Decree Law No. 7,661/45 (Article 52, vii)

Thus, if the buyer fails to notify the property owner's creditors about his intentions regarding the property, the transaction may be deemed ineffective, whether the purchaser was or was not aware of the debtor's insolvency, and whether it had or had not the intention of prejudicing the bankrupt party's creditors.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Subsequent to a finding of liability, the company, any of its shareholders, or an injured third party may bring suit against the responsible director to recoup losses[13].

QUESTION 6

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6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3, and 4 above, what remedies are available in the domestic court?

6.1 In order to have an act declared ineffective or revoked, the appropriate legal remedy under Brazilian law is the revocatory action ("*ação revocatória*"). The person entitled to file for revocation in a bankruptcy proceeding is the trustee. If the trustee does not file a revocatory action, any creditor will be entitled to do so. A revocatory action serves to declare the inefficacy, or the revocation, of a certain act performed by the debtor before bankruptcy was declared. The main goal of a revocatory action is to bring back into the bankrupt estate all assets which have been erroneously/fraudulently diverted from the estate by the debtor.

The revocatory action must be filed with the bankruptcy court within one year from the date in which the trustee published the notice regarding the beginning of the judicial sale of assets and payment of creditors[14].

The bankruptcy court may, at the request of the trustee, determine that all debtor assets which are in possession of third parties be subject to seizure[15]. Such a preventive measure aims to preserve the rights of those who have an interest in the referred to assets. If the court denies the trustee's request for seizure of assets, a bill of review may be filed by the trustee.

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[13] Corporation Law (Article 159)
[14] Article 56.1
[15] Article 55.3

An appellate review may be filed against the court's decision in a revocatory action. It must be filed within 15 days from the date in which the decision was rendered. The petition for appeal will not suspend the enforcement of the award if the challenged act was one of the acts listed in Article 52. However, in cases involving Article 53, the award will not be enforceable until a final decision is rendered by the appellate court[16].

If not already sold by the estate, goods acquired on credit by the bankrupt party which were delivered within fifteen days prior to the filing of a petition for bankruptcy may be returned[17]. To permit this return of goods, there are thus three requirements to be fulfilled: (i) the acquired goods have not yet been sold by the estate; (ii) the goods were acquired by the bankrupt party within fifteen days of the filing of the bankruptcy petition; and (iii) the goods were acquired on credit.

Article 54 provides for the restitution, to the bankrupt state, of assets which were the object of the nullified/revoked transactions referred to in Articles 52 and 53. When restitution is not possible, an indemnity must be paid by the contracting party. The bankrupt estate shall likewise pay restitution for whatever it received from by the contracting party, unless it gained no advantage from the agreement or act. Should the bankrupt party be deemed to not have benefited from the agreement or act, the contracting party shall be admitted as an unsecured creditor.

In the case of restitution, the creditor shall reassume its prior state and receive pro rata dividends as an unsecured creditor, if such is the case. Third parties in good faith shall be guaranteed the right to a claim for losses and damage, at any time, against the bankrupt party.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to cooperate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations?

7.1 Directors, creditors and debtors are required to provide accurate and timely information relating to insolvency investigations. Sanctions, which are similar to the finding of contempt of process in other jurisdictions, may be applicable in Brazil for non-compliance with an order or refusal to cooperate with the judicial process.

16 Article 55.2

17 Section 2, Article 76

The Bankruptcy Law states that a bankrupt corporation's directors and officers will be identified with the debtor and bankrupt party for criminal purposes. In this sense, if an administrator hides or destroy obligatory accounting books, thus hindering the progress of the bankruptcy proceedings, he may be held criminally liable[18].

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2.

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 The statute of limitation for filing a civil liability action against directors or other persons involved with the entity's administration is the same as that which is provided for in general civil liability actions, i.e., three years counting from the act that caused damage[19].

For criminal liability in connection with bankruptcy crimes, the statute of limitations is two years from the date in which the judicial award that terminates the bankruptcy proceeding or the "*concordata*" proceeding becomes unalterable[20]. Since bankruptcy proceedings in Brazil commonly extend beyond the maximum timeframe provided for in the law, which is two years, the Federal Supreme Court has stated that the statute of limitations for bankruptcy criminal liability will start from the date in which the bankruptcy should have been terminated ("*Súmula 147*").

Any interlocutory order issued in the course of the proceeding may be challenged by a bill of review ("*decisão interlocutória*") within ten days of the date in which the order was issued[21].

A lower court final decision may be challenged by an appeal[22]. The appeal must be filed within 15 days from the date in which the final decision was rendered and, in most cases, it will suspend the enforceability of the award until the appellate court rules on the appeal.

[18] Article 188.8
[19] Article 206, item V of Civil Code
[20] Article 199
[21] Article 522 of Code of Civil Procedure
[22] Article 513 of Code of Civil Procedure

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 There is no special liability regime governing foreign corporations in Brazil. These are subject to the same benefits, restrictions and regulations as Brazilian entities. However, there are slight restrictions on foreign entities, such as the foreign entity requirement to post a bond in order to initiate proceedings[23]. Also, foreign corporations shall be represented by a Brazilian attorney, provided that a duly executed power of attorney is furnished. This power of attorney must be notarized, "legalized", translated into Portuguese in Brazil by an authorized translator, and then registered with the appropriate Registry of Titles and Documents.

Foreign signatures (those not signed in Brazil) on any document that will be submitted to a Brazilian court must be notarized in the country of the signatory and then "legalized" at the nearest Brazilian Consulate's office. If documents are drafted in a language other than Portuguese, the translation must be done in Brazil, by an authorized translator, prior to the document being registered with the appropriate Registry of Titles and Documents ("*Cartório de Títulos e Documentos*").

Jurisdiction in bankruptcy matters is located at the principal place of business of a company ("*principal estabelecimento*") . As a result, proper jurisdiction may be in Brazil or abroad, depending on the facts of the case. If a debtor has their principal place of business in Brazil, a local civil court will take jurisdiction and Brazilian insolvency proceedings will be applicable to all of the debtor's assets, including those assets which are located outside of Brazil. A parallel bankruptcy proceeding outside of Brazil, with respect to the same debtor or the same assets, will have no legal effect on the Brazilian proceedings.

Brazilian Bankruptcy Law provides that the presence of a local office of a foreign business within Brazil will be sufficient to grant bankruptcy jurisdiction to a Brazilian civil court. This allows for the local courts to exercise territoriality jurisdiction in respect to foreign debtors doing business in Brazil. However, the applicability of these proceedings is likewise territorial. Only the foreign debtor's assets in Brazil will be subject to the court proceedings. For these purposes, a branch office will be treated like any Brazilian subsidiary or legal entity.

[23] Article 835 of Code of Civil Procedure

The bankrupt debtor, and by extension, its officers and directors, insofar as they relate to the bankruptcy proceeding, fall under the jurisdiction of the state civil court in the region where the debtor's main office is located. A single court will be responsible for the administration of the proceeding. If the officers or directors reside outside the court's administrative region, the court can exercise jurisdiction over them by a commission ("*precatória*") if they reside in Brazil, or by letters rogatory ("*carta rogatória*") if they reside abroad. Brazilian courts have absolute and exclusive jurisdiction over any action involving the debtor's assets located in Brazil. For jurisdictional purposes, an agency, office, branch or subsidiary of a foreign company which is located in Brazil will be considered domiciled in Brazil.

QUESTION 10

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10. Insurance

Is Director's and Officers' insurance available in you jurisdiction? If so, to what extent will the availability of such insurance policies provide effective protection to directors against personal liability which may arise in connection with the issues raised in question 1-9 above?

10.1 Director's and Officers' ("D&O") insurance is available in Brazil. However, should the company whose directors and officers wish to obtain the D&O insurance coverage be deemed insolvent, or fall under a similar status, insurance companies in Brazil will not issue a D&O policy to such company.

Unless there is a clause in the D&O insurance policy to exclude or limit the insurance coverage in the case of insolvency or bankruptcy, the contracted coverage will remain valid and effective with respect to the named officers and directors. This is true even if the D&O insurance policy is issued and immediately thereafter the company becomes insolvent or subject to a reorganization or bankruptcy proceeding.

D&O liability policies in Brazil are usually issued for a one-year term under a "claims made basis" (i.e., covering potential liabilities reported during the life of the policy and their respective dispositions for up to 36 months from the expiration of the policy term). Insurance premiums range from 0.5% to 3% of the insured value for limited liability companies and closely-held corporations (the precise percentage will depend on the company's financials, reputation and solidity) and between 1.5% to 10% of the insured amount for publicly-held corporations, which have a greater liability in relation to derivative actions and minority shareholder lawsuits.

D&O insurance policies in Brazil cover the personal liability of directors and officers, depending on the terms of the policy, by advancing funds for their defence in court and for payment of legal fees and costs and/or by refunding the amount of awards and damages judicially suffered. However, it is important to note that D&O coverage will only be effective for cases of liability arising from negligence or the non-intentional fault of the director or officer. Brazilian insurance laws prohibit insurance coverage against illicit acts committed with malice/intent, such as wilful misconduct. Therefore, illegal acts intentionally performed by an administrator (e.g., bankruptcy crimes) do not receive insurance coverage.

Directors and officers of joint stock companies and managers of limited liability corporations, including quota holders who are also managers of the company (managing quota holder), may obtain coverage through a D&O policy in Brazil pursuant to the above mentioned terms and conditions.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 Please see the issue of liabilities referred to in the above questions.

CANADA

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview [1]

The "twilight" period commences at the time that the directors and/or others become aware of the insolvency or the impending insolvency of the company. An insolvent person is defined in the *Bankruptcy & Insolvency Act* (Canada) (the "BIA") as a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and

(a) who is, for any reason, unable to meet his obligations as they generally become due;

(b) who has ceased paying his current obligations in the ordinary course of business as they generally become due; or

(c) the aggregate of whose property is not, at a fair valuation, sufficient, or if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable the payment of all his obligations due and accruing due.[2]

1.1.2 The "twilight" period will, as a general rule, terminate when formal insolvency procedures are commenced.

1.1.3 The definition of "corporation" in the BIA includes any company or legal person incorporated by or under an Act of Parliament or of any province, and any incorporated company, wherever incorporated, that is authorized to carry on business in Canada or that has an office or property in Canada, but does not include banks, authorized foreign banks within the meaning of section 2 of the Bank Act, insurance companies, trust companies, loan companies or railway companies.[3] The excluded entities are administered under the *Winding-Up and Restructuring Act,* R.S.C. 1985, c. W-11 ("WURA"). The specifics of the WURA are beyond the scope of this study, but many of the same principles set out in this study apply equally to corporations being administered under the WURA.

1.1.4 The review period under the BIA revolves around the phrase "date of initial bankruptcy event" which is used throughout the BIA to establish the effective date of bankruptcy in certain transactions. In the case of a voluntary assignment, the date of the initial bankruptcy event is the date of the filing or

[1] This paper makes reference to federal and provincial statutes. The provincial statutes cited are from Ontario, however, each provincial jurisdiction has comparable legislation.
[2] *Bankruptcy and Insolvency Act,* R.S.C. 1985, c. C-44, s. 2(1).
[3] BIA, s. 2(1).

the making of the assignment. In the case of a proposal, the date of initial bankruptcy event is the date a notice of intention or a proposal is filed. Where there has been a petition for a receiving order the date of the initial bankruptcy event is the date of the filing of the petition. At the termination of the review periods the phrase "date of bankruptcy", as referred to in this paper, refers to the date on which the insolvent person becomes bankrupt.

1.2 Does it depend on whether a formal insolvency procedure is instituted?

1.2.1 Transactions entered into by the corporation during the "twilight" period are vulnerable to attack and can give rise to personal liability on the part of directors and officers irrespective of whether or not formal insolvency proceedings are instituted. The liability of directors and officers is not entirely dependent on the existence of formal insolvency proceedings. Liability is based on a breach of fiduciary duty to the corporation and its stakeholders. However, the tests for reviewing certain transactions during the "twilight" period tend to be more objective than subjective if formal insolvency procedures have been instituted.

1.3 Does it depend on the nature of the transaction?

1.3.1 The objective of an insolvency regime is to ensure fair treatment to all stakeholders who have similar legal rights. There are a variety of different transactions that can be reviewed and the time period for such review varies depending on the nature of the transaction. The review periods are as follows:

(a) settlements under the BIA are void as against the trustee in bankruptcy if the settlement was made in the period beginning 1 year before the initial bankruptcy event and ending on the date that the settler becomes bankrupt. Insolvency is not a precondition to a finding of a settlement during this 1 year review period. However, in order for a settlement to be found in the period greater than 1 year before the initial bankruptcy event and up to 5 years before the initial bankruptcy event, the trustee must demonstrate that at the date of the settlement, the insolvent person was unable to pay all of its debts without the aid of the property in question.[4]

(b) fraudulent preferences under the BIA in favour of a creditor may also be void as against the trustee in bankruptcy. The review period is 3 months before the initial bankruptcy event and ending on the date of bankruptcy, but such period is extended to 1 year in the event of a transaction in favour of someone related to the insolvent person.[5]

(c) a reviewable transaction under the BIA exists where a bankrupt has been involved in a non-arms' length transaction during the period commencing 12 months before the initial bankruptcy event and ending on the date of bankruptcy.[6] The trustee is entitled to inquire into reviewable transactions for the purpose of determining whether a bankrupt has paid or received, as the case may be, fair market value for the property involved in the transaction. If the consideration given or received is conspicuously greater than or less than fair market value, the Court may grant judgment

[4] BIA, s. 91(1) and (2).
[5] BIA, s. 95 and 96.
[6] BIA, s. 100(1).

in favour of the trustee for the difference between the actual consideration given or received and the fair market value of the property involved in the transaction. Pursuant to such a judgment, the trustee may recover from other parties to the transaction and/or any other person being privy to the transaction.

(d) where a corporation has paid a dividend, other than a stock dividend, or redeemed or purchased for cancellation any of the shares of the stock of the corporation within the period commencing on the day that is 1 year before the initial bankruptcy event and ending on the date of bankruptcy, the Court may, on application by the trustee under the BIA, inquire into the transaction to ascertain whether it occurred at a time when the corporation was insolvent or whether it rendered the corporation insolvent.[7] If the transaction occurred at such a time, the Court may give judgment to the trustee against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest, that has not been paid to the corporation, provided that the Court finds that (i) the transaction occurred at a time when the corporation was insolvent or the transaction rendered the corporation insolvent; and (ii) the directors did not have reasonable grounds to believe that the transaction was occurring at a time when the corporation was not insolvent or that the transaction would not render the corporation insolvent.

Directors have the onus of proving that the corporation was not insolvent at the time of the transaction and/or that the directors had reasonable grounds to believe that the transaction was occurring at a time when the corporation was not insolvent.

A director is protected from the provisions of this section if such director protested against the payment of the dividend or the redemption or purchase for the cancellation of shares of the stock of the corporation. If the trustee is able to fulfil the requirements of the statute, the Court may give judgment to the trustee against a shareholder who is related to one or more of the directors, in the amount of the dividend or redemption or purchase price referred to.

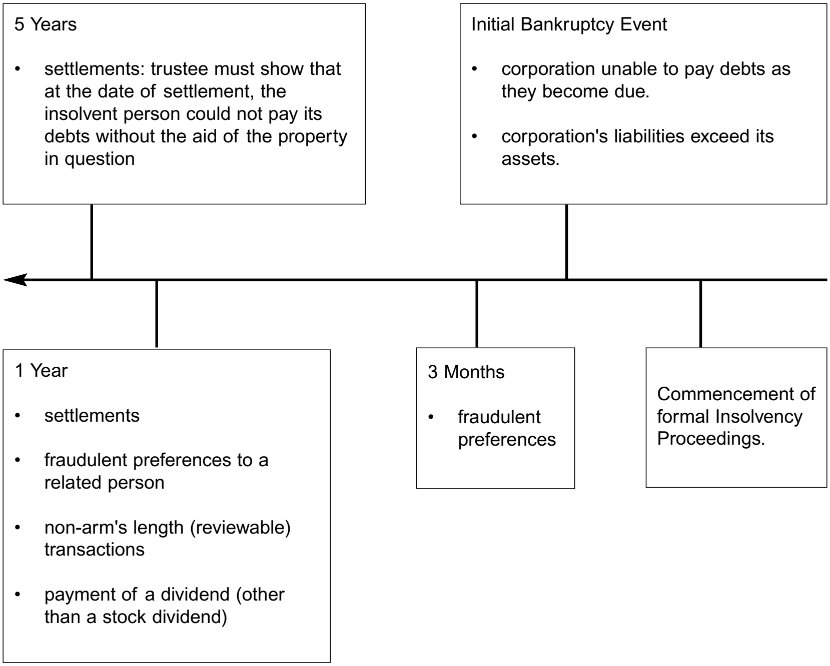
(e) a trustee in bankruptcy can also resort to statutes other than the BIA.The *Fraudulent Conveyances Act*[8] is one such example. This legislation, which is enacted at a provincial level, enables the trustee or other creditors to attack any transaction that was entered into with the intention of defeating, delaying or hindering creditors. In Ontario, the limitation period to challenge transactions is 2 years from the time when the plaintiff first became aware of the fraudulent conveyance.

(f) a sale in bulk is voidable unless the buyer has complied with the provisions of the *Bulk Sales Act.*[9] If a sale in bulk has been set aside or declared void and the buyer has taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof.

(g) although it is beyond the scope of this study, directors are also liable to

[7] BIA, s. 101(1).
[8] R.S.O. 1990, c. F. 29.
[9] R.S.O. 1990, c. B-14 (the “BSA”).

ensure that certain statutory trust deductions from employee wages are remitted to the governmental taxing authorities.These trusts include income tax, pension plan contributions and employment insurance.



1.4 Does it depend on whether the party to the transaction is connected or associated with the company?

1.4.1 The length of the “twilight” period can depend on whether the party to the transaction is (a) related; or (b) dealing at arm’s length with the bankrupt. For example, if the parties are related, which generally means a blood relation among individuals or actual control among corporations, then the period in which to review fraudulent preferences is extended from three months to one year.

1.5 Will any other circumstances lengthen or shorten the “twilight” period?

1.5.1 A statutory compromise of the corporation’s liability does not in itself relieve a director or officer of their personal liability. However, where the corporation makes a proposal to its creditors under the BIA, the BIA specifically authorizes, in certain circumstances, the release of claims against directors for liabilities incurred in their capacity as such. A proposal under the BIA or a proposed plan of arrangement under the *Companies’ Creditors Arrangement Act* (Canada) (“CCAA”) may provide for the compromise of claims against directors if:

(a) the claims do not relate to the creditor's contractual rights against such directors;

(b) the claims are not based on allegations of either misrepresentation, wrongful or oppressive conduct by directors toward creditors; and

(c) the Court determines the compromise to be fair and reasonable in the circumstances.[10]

1.5.2 The legislation does not address compromise of claims against officers. However, recent cases have held that if the plan of arrangement contains or, at least for the corporations' officers, is approved by the various constituencies, it should be viewed as a contract between the debtor and its creditors and should not be interfered with by the Court.[11]

1.5.3 In order to obtain maximum protection, directors usually try to ensure that a proposal under the BIA or a proposed plan of arrangement under the CCAA provides specifically for the release of claims by creditors against them. Such provisions will be effective to the extent permitted by the relevant statute.

QUESTION 2

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2 Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

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10 BIA, s. 50(13) and (14); *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, s. 5.1.

11 Re Canadian Airlines Corp. (2000), 20 C.B.R. (4th) 1 (Alta. Q.B.) at 23.

2.1 Recent Developments – Senate Committee Report

In November 2003, after a detailed review of the BIA and the CCAA, the Standing Senate Committee on Banking, Trade and Commerce (the "Senate Committee") tabled a report which contains a number of recommendations.[12] Although the Senate Committee recommendations are not yet law, the report states that amendments to the relevant legislation are expected to follow. One of the recommendations pertains to directors' liability and suggests that the BIA be amended to include a generally applicable due diligence defence against personal liability for directors.[13] The Senate Committee also recommended that the BIA and CCAA be amended to ensure consistent and simplified rules for challenging fraudulent preferences, conveyances at undervalue and other reviewable transactions.[14] Further, the Senate Committee recommended that the BIA and CCAA provide a standard for challenging transactions that may affect the value of creditors' realizable claims.[15]

2.2 General fiduciary duties

2.2.1 Directors are subject to certain general fiduciary duties imposed by corporate law statutes. In performing their functions, directors are required to:

(a) act honestly and in good faith with the view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

2.2.2 The traditional view is that a director owes these fiduciary duties to the corporation and its shareholders but not to creditors. However, there is case law in Canada that follows the approach taken in other common law jurisdictions (i.e. England, Australia, New Zealand), which suggest that when a corporation is insolvent the directors cannot disregard the interests of the creditors. The issue as to whether a director owes a duty to creditors when a corporation is insolvent has recently been determined by the Supreme Court of Canada in *Peoples Department Stores Inc. v. Wise*.

2.2.3 In the lower court decision of *Peoples Department Stores Inc. v. Wise*, the court held that there may be a fiduciary duty on the part of the directors of a company to act in the best interest of creditors.[16] If a company goes into bankruptcy, the directors may be liable to the bankrupt estate if they should have appreciated or ought to have known that a transaction carried out by the company when it was insolvent, or whose solvency was jeopardized by the transaction, was likely to cause loss to the creditors. However, on appeal, the Quebec Court of Appeal held that directors owe no such duty to creditors.[17] The Court of Appeal decision was appealed to the Supreme Court of

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[12] Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, Report of the Standing Committee on Banking, Trade and Commerce, November 2003.
[13] Ibid, p.121.
[14] Ibid, p.124.
[15] Ibid.
[16] (1998), 23 C.B.R. (4th) 200 (Que. S.C.); see also Dylex Ltd. *(Trustee of) v. Anderson* (2003), 63 O.R. (3d) 659 (Ont. S.C.J. *[Commercial List])*.
[17] (2003), 41 C.B.R. (4th) 225 (Que. C.A.).

Canada. Canada's highest court. In its decision released on October 29, 2004 the Supreme Court of Canada dismissed the appeal and held that directors owe a fiduciary duty to the corporation and not the corporation's creditors, regardless of whether the corporation is in the "vicinity of insolvency".[18] However, the Supreme Court recognized that, in certain circumstances, it may be legitimate for a director to consider the interests of shareholders, employees, creditors and others when assessing the best interests of the corporation. Although such other interests may be considered, the Supreme Court held that a director's fiduciary duty does not change simply because a corporation is in the "vicinity of insolvency". The Supreme Court held that an honest good faith attempt by a director of a corporation to address a corporation's financial problems does not, if unsuccessful, qualify as a breach of a director's fiduciary duty to the corporation. The Supreme Court further held that it is unnecessary to read the interests of creditors into the fiduciary duty since creditors have the oppression remedy (discussed in section 2.8 herein) available to them.

2.2.4 It was held in a decision of the Ontario Court that even if lawyers who perform legal work for a company in connection with a transaction do not act purposefully or knowingly participate in the transaction, they may still be liable to the trustee in bankruptcy for their participation in the transaction if they acted recklessly or were wilfully blind to the actions of the company.[19]

2.3 General Bankruptcy Offences under the Bankruptcy and Insolvency Act ("BIA")

2.3.1 Where a corporation commits an offence under the BIA, any officer or director of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is guilty of the offence and is liable upon conviction for the punishment provided for the offence.[20]

2.3.2 Personal liability will follow where an officer or director:

(a) makes any fraudulent disposition of the bankrupt's property before or after the date of the initial bankruptcy event;

(b) refuses or neglects to answer fully and truthfully all proper questions put to the bankrupt at any examination held pursuant to the BIA;

(c) makes a false entry or knowingly makes a material omission in a statement or accounting;

(d) after or within 1 year immediately preceding the date of the initial bankruptcy event, conceals, destroys, mutilates, falsifies, makes an omission in or disposes of, or is privy to the concealment, destruction, mutilation, falsification, omission from or disposition of, a book or document affecting or relating to the bankrupt's property or affairs, unless the bankrupt had no intention to conceal the state of the bankrupt's affairs;

[18] At the time of printing, the Supreme Court of Canada's decision in *Peoples Department Stores v Wise* was unreported.
[19] *Canbook Distribution Corp. v. Borins* (1999), 45 O.R. (3rd) 565 (Ont. S.C.J. [Commercial List]).
[20] BIA, s. 204.

(e) after or within 1 year immediately preceding the date of the initial bankruptcy event, obtains any credit or any property by false representations made by the bankrupt or made by any other person to the bankrupt's knowledge;

(f) after or within 1 year immediately preceding the date of the initial bankruptcy event, fraudulently conceals or removes any property of a value of $50 or more or any debt due to or from the bankrupt; or

(g) after or within 1 year immediately preceding the date of the initial bankruptcy event, hypothecates, pawns, pledges or disposes of any property that the bankrupt has obtained on credit and has not paid for, unless in the case of a trader the hypothecation, pawning, pledging or disposing is in the ordinary way of trade and unless the bankrupt had no intent to defraud.[21]

2.3.3 If any of (a) – (g) above are satisfied:

(a) liability is criminal;

(b) a person guilty of the offence is liable:

(i) on summary conviction, to a fine not exceeding $5000 or to imprisonment for a term not exceeding 1 year, or to both; or

(ii) on indictment, to a fine not exceeding $10,000 or to imprisonment for a term not exceeding 3 years, or to both;

(c) the gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered (subject to the maximum restriction);

(d) the specified period within which the relevant act must have been undertaken in order for liability to attach to a director is described in 2.3.2(a) - (g); and

(e) absence of an intention to defraud or conceal amounts to a defence.

2.4 Failure to keep proper books of account

2.4.1 The offence is made out if any officer or director is involved in a corporation which has become bankrupt or has made a proposal and the corporation has, on a previous occasion, been bankrupt or made a proposal:

(a) while engaged in any trade or business and has not kept and preserved proper books of account; or

(b) has concealed, destroyed, mutilated, falsified or disposed of, or is privy to the concealment, destruction, mutilation, falsification or disposition of, any book or document affecting or relating to the corporation's property or affairs.[22]

[21] BIA, s. 198(1).
[22] BIA, s. 200(1).

2.4.2 If 2.4.1 above is satisfied, and the impugned transaction occurred within the period beginning 2 years before the initial bankruptcy event and ending on the date of bankruptcy, then section 2.3.3 (a) to (c) and (e) above apply.

2.5 Unlawful transactions

2.5.1 The offence is made out where the director or officer participates in a transaction entered into by the bankrupt corporation with any person for the purpose of obtaining a benefit or advantage to which either of them would not be entitled.[23]

2.5.2 Provided 2.5.1 above is satisfied:

(a) liability is criminal;

(b) the person guilty of the offence is liable on summary conviction, to a fine not exceeding $5,000 or to imprisonment for a term not exceeding 1 year, or to both;

(c) the gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered (subject to the maximum restriction);

(d) this offence applies after the corporation becomes bankrupt; and

(e) absence of intent to obtain a benefit or advantage amounts to a defence.

2.6 Declaration of dividends

2.6.1 Where the court finds that either the bankrupt corporation paid a dividend, other than a stock dividend, or redeemed or purchased for cancellation any of the shares of its capital stock at a time when the corporation was insolvent or the transaction rendered the corporation insolvent, the directors of the corporation are personally liable.[24]

2.6.2 Where 2.6.1 above has occurred:

(a) liability is civil;

(b) a director found guilty of this offence is liable to pay to the trustee the amount of the dividend, redemption or purchase price with interest;

(c) the liability will attach to the directors jointly and severally;

(d) the declaration of dividends must have occurred within the 1 year period immediately preceding the date of the initial bankruptcy event and ending on the date of the bankruptcy; and

(e) the following defences exist:

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[23] BIA, s. 201(3).

[24] Canada Business Corporations Act, R.S.C. 1985, c. C-44, s. 42 (“CBCA”); and Ontario Business Corporations Act, R.S.O. 1990, c. B. 16, s. 38(3) (“OBCA”). (Note: Provinces other than Ontario have their own Business Corporations Act).

(i) the director actively dissented from the resolution authorizing the payment of the dividend; or

(ii) the director had reasonable grounds to believe that the impugned transaction occurred at a time when the corporation was solvent or that the transaction would not render the corporation insolvent.[25]

2.7 Liability for debts due to employees

2.7.1 According to corporate statutes such as the CBCA, the directors of a corporation are personally liable to the employees for all debts, not exceeding 6 months wages, for services performed for the corporation.[26] The directors are also liable for any vacation pay that accrued over a period of up to 12 months while they were directors.

2.7.2 Where 2.7.1 above is satisfied:

(a) liability is civil;

(b) the court may order the directors to pay the debts owed to the employees, with interest at such rate as the court sees fit;

(c) the directors are jointly and severally liable for the debt;

(d) there is no specified period within which the relevant act must have been undertaken in order for liability to attach; and

(e) a director is not liable unless:

(i) the corporation has been sued within 6 months after the debt was due and execution has been returned unsatisfied either in whole or in part; or
(ii) the corporation has made an assignment or a receiving order has been made against it under the BIA and a claim for the debt has been proved within 6 months after the date of the assignment or receiving order.

It should also be noted that the director is not liable unless he or she is sued while he or she is a director or within 2 years after ceasing to be a director.

2.8 Oppression and derivative action

2.8.1 A complainant may apply to the court for an order under the oppression provisions of the CBCA to rectify the matters complained of if the court is satisfied that in respect of a corporation or any of its affiliates:

(a) any act or omission of the corporation or any of its affiliates effects a result;

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

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25 BIA, s. 101(2)
26 CBCA, s. 119.

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer and the court may make an order to rectify the matters complained of.[27]

2.8.2 Where 2.8.1 above is satisfied:

(a) liability is civil;

(b) the court may make an order to compensate the aggrieved person;

(c) there is no evidence that the court cannot apportion liability to each individual director according to their specific involvement when the court makes an order to compensate the aggrieved person;

(d) there is no specified period within which the relevant act must have been undertaken in order for liability to attach; and

(e) if the directors can show that the exercise of their powers was not oppressive or unfairly prejudicial or unfairly disregarded the interests of any security holder, creditor, director or officer, then the elements of the offence would not have been established and the action would fail.

2.8.3 The Court may make an interim or final order which it thinks fit including:

(a) an order restraining the conduct complained of;

(b) an order appointing a Receiver or Receiver/Manager;

(c) an order to regulate a corporation's affairs by amending the articles or by-laws or creating or amending a Unanimous Shareholder Agreement;

(d) an order directing an issue or exchange of securities;

(e) an order appointing directors in place of or in addition to all or any of the directors then in office;

(f) an order directing a corporation or any other person, to purchase securities of a security holder;

(g) an order directing a corporation or any other person, to pay a security holder any part of the money paid by the security holder for securities;

(h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(i) an order requiring a corporation, within a time specified by the Court, to produce to the Court or an interested person financial statements or an accounting in such other form as the Court may determine;

27 CBCA, s. 241(2).

(j) an order compensating an aggrieved person;

(k) an order directing rectification of the registers or other records of the corporation;

(l) an order winding-up the corporation;

(m) an order directing an investigation; and

(n) an order requiring the trial of any issue.[28]

General Liability under the BIA

2.9 Community Service

2.9.1 Where a person has been convicted of an offence under the BIA, the court may, having regard to the nature of the offence and the circumstances surrounding its commission, and in addition to any other punishment that may be imposed under the BIA, make an order directing the person to perform community service, subject to such reasonable conditions as may be specified in the order.[29]

2.10 Compensation for loss

2.10.1 Where a person has been convicted of an offence under the BIA and any other person has suffered loss or damage because of the commission of the offence, the court may, at the time sentence is imposed, order the person who has been convicted to pay to the person who has suffered loss or damage or to the trustee of the bankrupt, an amount by way of satisfaction or compensation for loss of or damage to property suffered by that person as a result of the commission of the offence.[30]

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

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[28] OBCA, s. 248(3); CBCA, s. 240(3).
[29] BIA, s. 204.1
[30] BIA, s. 204.3(1)

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Introduction

3.1.1 The BIA clearly stipulates that an agent of the corporation or any person who has or has had de facto control of the corporation, whether directly or indirectly, may be held liable for an offence under the BIA.[31]

3.1.2 In addition, there are a number of transactions entered into during the "twilight" period for which third parties who do not control the corporation may be held liable.

3.2 Reviewable transactions

3.2.1 If the bankrupt enters into a transaction with a non-arm's length third party, and the consideration for the transaction is "conspicuously greater or less than the fair market value of the property or services", then the court may give judgment to the trustee against any other party to the transaction or against any other party privy to the transaction. The party subject to such judgment is required to pay the difference between the actual consideration given or received, as the case may be, by the bankrupt and the fair market value of the property or services.

3.3 Fraudulent preferences, settlements and fraudulent conveyances

3.3.1 The third party may be held liable when an insolvent corporation enters into a transaction with a creditor of the corporation. If the court holds that the transaction was made at a time when the corporation was insolvent with an intention to prefer that creditor over others, then the transaction will be void as against the trustee. The review period is 3 months before the initial bankruptcy event, with an extension to 1 year in the event of related parties. From a practical standpoint, this means that the creditor of the corporation will be obligated to return to the trustee any consideration paid by the bankrupt in the transaction.

3.3.2 Similarly, the recipient of a settlement or the transferee of property in a fraudulent conveyance will also be obligated to return property to the trustee if the transaction is set aside as being a settlement or a fraudulent conveyance.

3.4 Liability of persons convicted of BIA Offences

3.4.1 See section 2.9 and 2.10.

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[31] BIA, s. 204.

QUESTION 4

4. Counterparties dealing with the company during the "twilight" period

(a) From the point of view of a counterparty dealing with the company during the "twilight" period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counterparty seeking to protect a transaction from being attacked?

4.1 Introduction

4.1.1 There are a number of potential remedies available to creditors and/or the trustee in bankruptcy all of which have at their root the equitable principle that unsecured creditors should be treated equally.

4.1.2 The potential heads of challenge which may lead to transactions being set aside are transactions:

(a) for conspicuously greater or less than fair market value;

(b) which are preferences;

(c) which are settlements;

(d) which are fraudulent conveyances;

(e) which involve dispositions of property after the commencement of bankruptcy proceedings;

(f) which do not comply with provincial bulk sales legislation; or

(g) which are oppressive.

4.2 Reviewable transactions [32]

4.2.1 For the purposes of the BIA, a person who has entered into a transaction with another person otherwise than at arm's length shall be deemed to have entered into a reviewable transaction. It is a question of fact whether persons not related to one another within the meaning of the BIA were at the particular time dealing with each other at arms length. Persons who are related within the meaning of the BIA are deemed not to deal with each other at arm's length.

4.2.2 Where a bankrupt has entered into a reviewable transaction in the 1 year period before the initial bankruptcy event and ending on the date of

[32] BIA, s. 100.

bankruptcy, the court may, on the application of the trustee, inquire into whether the bankrupt gave or received fair market value in consideration for the property or services concerned in the transaction.

4.2.3 Where the court in proceedings under this section finds that the consideration given or received by the bankrupt in the reviewable transaction was conspicuously greater or less than fair market value, the court may give judgment to the trustee against the other party to the transaction, or against any other person being privy to the transaction with the bankrupt, or against all those persons, for the difference between the actual consideration given or received by the bankrupt, and the fair market value as determined by the court, of the property or services concerned in the transaction.

4.2.4 In making an application under this section, the trustee shall state what in his or her opinion was the fair market value of the property or services concerned in the transaction and what in his or her opinion was the value of the actual consideration given or received by the bankrupt in the transaction.

4.2.5 The application of this section of the BIA is subject to 3 conditions:

(a) the transaction must have taken place during the period commencing 1 year before the initial bankruptcy event and ending on the date of bankruptcy;

(b) the transaction must have been at a price manifestly different from fair market value, that is for an inadequate consideration; and

(c) the transaction must be reviewable, i.e. with a person who was not at arm's length with the bankrupt.

4.2.6 The test for whether or not the difference in the consideration is conspicuous is not whether it was conspicuous to the parties at the time, but whether it is conspicuous to the court having regard to all relevant factors. "Conspicuous" means "remarkable" and "noteworthy".

Defence

4.2.7 It should be noted that even if all the conditions of this section have been met, the courts in certain jurisdictions in Canada still believe that the duty to grant judgment against any or all the persons named in this section is permissive, not mandatory, and that the court has a discretion not to grant a remedy, if equitable principles so mandate.

4.3 Fraudulent preferences[33]

4.3.1 By way of overview, a preference arises when an insolvent person enters into a transaction and subsequently becomes bankrupt and the transaction results in a creditor being put in a better position than he or she would have been in if the company had instead gone into liquidation. The attack is made by a trustee in bankruptcy and the courts have the ability to declare the transaction to be fraudulent and void as against the trustee.

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[33] BIA, s. 95 and 96.

4.3.2 The provisions of the BIA with respect to preferences are a means of carrying into effect the principle of the BIA, contained in section 141, that all ordinary creditors should rank equally. Subsection 95(1) makes every conveyance, transfer, charge etc. made by an insolvent person with a view to preferring a creditor within 3 months before the initial bankruptcy event and ending on the date the insolvent person becomes bankrupt, fraudulent and void. Section 96 extends the period to 1 year before the initial bankruptcy event in the case where the creditor is related to the insolvent person.

4.3.3 For the purposes of the BIA, persons are "related persons" if they are:

(a) individuals connected by blood relationship, marriage or adoption;

(b) a corporation and

(i) a person who controls the corporation, if it is controlled by one person,

(ii) a person who is a member of a related group that controls the corporation, or

(iii) any person connected in the manner set out in paragraph (a) to a person described in subparagraph (i) or (ii); or

(c) two corporations

(i) controlled by the same person or group of persons,

(ii) each of which is controlled by one person and the person who controls one of the corporations is related to the person who controls the other corporation,

(iii) one of which is controlled by one person and that person is related to any member of a related group that controls the other corporation,

(iv) one of which is controlled by one person and that person is related to each member of an unrelated group that controls the other corporation,

(v) one of which is controlled by a related group a member of which is related to each member of an unrelated group that controls the other corporation, or

(vi) one of which is controlled by an unrelated group each member of which is related to at least one member of an unrelated group that controls the other corporation.[34]

4.3.4 For the purposes of the BIA, "relationship" is:

(a) where two corporations are related to the same corporation within the meaning of subsection 4(2), they shall be deemed to be related to each other;

[34] BIA, s. 4(2).

(b) where a related group is in a position to control a corporation, it shall be deemed to be a related group that controls the corporation whether or not it is part of a larger group by whom the corporation is in fact controlled;

(c) a person who has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares in a corporation, or to control the voting rights or shares in a corporation, shall, except where the contract provides that the right is not exercisable until the death of an individual designated therein, be deemed to have the same position in relation to the control of the corporation as if he owned the shares;

(d) where a person owns shares in two or more corporations, he shall, as shareholder of one of the corporations, be deemed to be related to himself as shareholder of each of the other corporations;

(e) persons are connected by blood relationship if one is the child or other descendant of the other or one is the brother or sister of the other;

(f) persons are connected by marriage if one is married to the other or to a person who is connected by blood relationship to the other; and

(g) persons are connected by adoption if one has been adopted, either legally or in fact, as the child of the other or as the child of a person who is connected by blood relationship, otherwise than as a brother or a sister to the other.[35]

4.3.5 The BIA states that the intent to prefer is to be presumed, in the absence of evidence to the contrary, if the effect of the conveyance, transfer, charge etc. is to give the creditor a preference over other creditors.[36]

4.3.6 If a payment or other disposition of property is made in circumstances that amount to a fraudulent preference, the transaction remains valid unless or until it is set aside as a fraudulent preference. The mere fact that a creditor obtains a preference is not ipso facto proof of a fraudulent intention on the part of the debtor. To constitute a fraudulent preference, there must be both a preference in fact and an intention on the part of the debtor to prefer.

4.3.7 Transactions within the time periods referred to in section 95 (see 4.3.2) and section 96 that take place in the ordinary course of business are generally protected.

4.3.8 “Fraudulent” in section 95 does not mean actual fraud, but constructive or legal fraud. Constructive fraud is conduct that is characterized as fraudulent by the law, not because it is necessarily per se reprehensible, but because it tends to damage the public interest.

4.3.9 To attack a transaction as a fraudulent preference, the trustee must prove that the conveyance was made to a creditor.

Transaction must take place within 3 months (or 1 year if related) before bankruptcy.

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[35] BIA, s. 4(3).
[36] BIA, s. 95(2).

4.3.10 If the transaction sought to be set aside took place more than 3 months before the initial bankruptcy event (1 year in the case of related parties), resort can be had to the remedies provided by provincial statutes not in conflict with the BIA.

4.3.11 The 3 month or 1 year period is calculated from the date of the initial bankruptcy event and ends on the date that the insolvent person becomes bankrupt.[37] The date of the initial bankruptcy event provides for a dating back and is most important in the case of receiving orders and deemed assignments. In receiving orders, the date of the initial bankruptcy event will be the date of the filing of the petition and the 3 month or 1 year period is calculated from that date. The date when the relevant period ends is the date of the receiving order, assignment, or the date of the event that causes an assignment in bankruptcy to be deemed.

4.3.12 The date for the commencement of the 3 month or 1 year period is the date when the payment was made, the obligation was incurred, or the judicial proceeding was taken, not the date when the intention was formed to make the payment, incur the obligation, or take the judicial proceeding.

Insolvency of debtor

4.3.13 Fraudulent preference remedies can only be invoked if the transaction was effected by an “insolvent person”. It is not necessary for the trustee to prove an act of bankruptcy by the debtor, it is only necessary to prove that the debtor was insolvent at the time of the transaction. Please see section 1.1.1 for the definition of insolvent person.

Intention

4.3.14 In order to constitute a fraudulent preference, the transaction must be entered into “with a view to giving that creditor a preference”. The words “with a view to giving that creditor a preference” require only an intention on the part of the debtor. In determining the intention of the debtor, the test is an objective one, not a subjective one (i.e. the intention will be that which the debtor’s conduct bears when reasonably construed and not that which, long after the event, he claims was his intention).

The presumption

4.3.15 Under section 95 the trustee is required to prove:

(a) that the transaction took place within 3 months or 1 year of the initial bankruptcy event;

(b) that the debtor was an insolvent person at the date of the alleged preference; and

(c) that at the date when the transaction was effected, it gave the creditor a preference in fact over other creditors.

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[37] BIA, s. 95 and 96

4.3.16 When the trustee has proved these three essentials, the transaction is presumed to have been effected with the view to giving a creditor a preference over other creditors.[38]

Defences

4.3.17 The presumption can be rebutted by the defendant to the transaction. If, after considering all the evidence, the court is satisfied that on the balance of probabilities the debtor was pursuing a purpose other than that of favouring the particular creditor over other creditors, the presumption will be displaced and the trustee's application will be dismissed. For example, if the court concludes that a payment was made in the ordinary course of business and not with the intention to prefer, the presumption will have been rebutted and the payment will stand. Payments in the ordinary course of business will ordinarily be made for 1 of 2 reasons:

(a) so that the bankrupt might take advantage of favourable payment terms; or

(b) to secure a continued supply of goods or services from the trade creditor so that the bankrupt could continue in business.

4.3.18 Examples of other defences that can be raised by creditors include that of a diligent creditor continuing to press for payment, security given for present advances, a binding agreement to make payment or to give security made prior to the review period, or where there is no reason to prefer the creditor.

4.4 Provincial legislation dealing with preferences

4.4.1 In addition to attacking a transaction under the BIA, it may be possible for a trustee in the common law provinces to make use of provincial acts dealing with fraudulent preferences. *The Assignments and Preferences Act*[39] ("APA") is ordinarily used by a trustee in bankruptcy when the time limits under section 95 of the BIA have expired. Under the APA , it is necessary to prove (a) a gift, conveyance, assignment or transfer or delivery over; (b) an intent to give a creditor an unjust preference over creditors or over any one of them; and (c) at the time of the gift, conveyance, assignment or transfer or delivery over, the debtor was in insolvent circumstances.[40] Although the wording is different from section 95 of the BIA, these requirements are substantially similar to those provided by section 95. However, there are some important differences which generally speaking make it more difficult to prove a preference under the Assignments and Preferences Act.

4.5 Settlements

4.5.1 Under the BIA, all settlements of property are void if bankruptcy occurs within 1 year after the date of the settlement. Settlements made more than 1 year after but within 5 years of the date of bankruptcy are void where the trustee can demonstrate either that, at the date of the settlement, the settlor was

[38] BIA, s. 95(2).
[39] R.S.O. 1990, c. A. 33
[40] BIA, s. 4.

unable to pay all its debts without the aid of the property in question or that the interest of the settlor did not pass on the execution of the settlement.[41]

4.5.2 A settlement, which falls within section 91, is not void but only voidable. It only becomes void when bankruptcy occurs. It is not void as of the date of the making of the conveyance or the date when the court makes the order declaring it to be a settlement, it is the bankruptcy which is the triggering event.

4.5.3 Since 1992, the BIA has provided a partial definition of "settlement". Under this definition "settlement" includes a contract, covenant, transfer, gift and designation of a beneficiary in an insurance contract to the extent that the contract, covenant, transfer, gift or designation is gratuitous or made for merely nominal consideration.[42] There must also be an intention that the property will be retained for the benefit of the done in some form.[43]

4.5.4 The trustee does not have to prove a fraudulent intention on the part of the settlor in order to obtain an order setting aside a settlement.

4.5.5 It is important to distinguish between a settlement and a fraudulent preference. A settlement involves a gift to a stranger to the bankruptcy. A preference involves a transaction with a creditor whereby the creditor is preferred over other creditors. A settlement involves the idea of a clear gift or a situation where provision is made for a trust of some sort, so it would not typically include a business transaction between a debtor and a creditor.

Defence

4.5.6 The provisions of section 91 do not apply to any settlement made in favour of a purchaser or encumbrancer in good faith and for valuable consideration. Both elements must be proved in order to come within this exception.

4.6 Fraudulent conveyances

4.6.1 The provincial *Fraudulent Conveyances Act* does not conflict with the BIA, and a trustee in bankruptcy is entitled to make use of such legislation to supplement the rights and remedies provided by the BIA.

4.6.2 The effect of the *Fraudulent Conveyances Act* is that a conveyance that is fraudulent and voided against creditors is not absolutely void but only voidable, the conveyance is good as between the parties to it.

4.6.3 *The Fraudulent Conveyances Act* renders void a conveyance of property made with the intent to defeat, hinder, delay or defraud creditors or others. The act makes an important distinction between voluntary conveyances and conveyances made for good consideration.[44] If a conveyance is voluntary, it is only necessary to show the fraudulent intent of the maker; if it is made for good consideration, it is necessary to show the fraudulent intent of both parties to the transaction.

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41 BIA, s. 91.
42 BIA, s. 2.1.
43 *Royal Bank v. Whalley* (2002), 34 C.B.R. (4th) 277 (Ont. C.A.)
44 Fraudulent Conveyances Act, R.S.O. 1990, c. F. 29, s. 2.

4.6.4 Under the *Fraudulent Conveyances Act*, the plaintiff does not have to show that the creditors were in fact delayed, defeated or defrauded, only that the grantor had an intention to defeat, hinder, delay or defraud creditors.

4.6.5 If there is no consideration for a conveyance, it is irrelevant whether or not the grantee had notice or knowledge of the fraudulent intent of the grantor. In the case of a voluntary conveyance, the trustee in bankruptcy need only prove that the grantor had the intent to defeat, hinder, delay or defraud creditors.

4.6.6 If the court finds a transaction to be a fraudulent conveyance, the trustee will be entitled to a declaration that the conveyance is void as against him and that he is the owner of the bankrupt's interest in the property.

Defences

4.6.7 The court may not make an order setting aside the transaction if it is satisfied that there was no intent to defeat, hinder, delay or defraud creditors or others.

4.6.8 Even if the court finds that the transaction was a fraudulent conveyance, it is not void if it was made for good consideration and bona fide to a person not having, at the time of the conveyance, notice or knowledge of the intent to defraud.

4.7 Protection of transaction made in good faith with bankrupt

4.7.1 The purpose of section 97(1) of the BIA is to deal with the effect of the relation back of the trustee's title in various sections of the BIA, such as section 95 which deals with fraudulent preferences. Section 97(1) applies to payments, conveyances etc. which take place between the date of the initial bankruptcy event and the date of bankruptcy. Four types of transactions as set out in paragraphs (a) – (d) are protected if made in good faith and if they do not constitute a settlement, preference or reviewable transaction. The four headings are:

(a) a payment by the bankrupt to any of the bankrupt's creditors;

(b) a payment or delivery to the bankrupt;

(c) a conveyance or transfer by the bankrupt for adequate valuable consideration;

(d) a contract, dealing or transaction including any giving of security, by or with the bankrupt for adequate valuable consideration.

4.7.2 With respect to such protected transactions, the law of set-off applies in the same manner and to the same extent as if the bankrupt were the plaintiff or defendant, as the case may be, except insofar as any claim for set-off is affected by the provisions of the BIA respecting frauds or fraudulent preferences.

4.8 Bulk Sales Legislation

4.8.1 Purpose and Application of BSA

Although bulk sales legislation has been repealed in most Canadian jurisdictions, it is still applicable in Ontario, Newfoundland and New Brunswick.[45] Bulk sales legislation was introduced to protect creditors from a secret though valid sale of the debtor's stock and a possible unfair distribution or dissipation of the proceeds of such a sale.

In Ontario, the BSA applies to every "sale in bulk" which is defined as a "sale of stock in bulk out of the usual course of business or trade of the seller".[46] "Stock in bulk" is defined as stock which is the subject of a sale in bulk and all other property, real or personal, that together with stock is the subject of a sale in bulk.[47] "Stock" is defined as:

(i) goods, wares, merchandise or chattels ordinarily the subject of trade and commerce,

(ii) the goods, wares, merchandise or chattels in which a person trades or that the person produces or that are the output of a business, or

(iii) the fixtures, goods and chattels with which a person carries on a trade or business.

The BSA applies to virtually every sale of stock out of the usual course of business of the seller, subject to certain specific exceptions, such as a sale by a receiver, assignee or trustee for the benefit of creditors, trustee under the BIA, liquidator or official receiver.

The term "sale" includes a transfer, conveyance, barter or exchange but does not include a pledge, charge or mortgage.[48]

4.8.2 Disclosure of Creditors

Section 4 of the BSA prohibits the purchaser from delivering a sum more than of 10% of the final purchase price to the vendor until the purchaser has received from the vendor:

(a) a list of names and addresses of the unsecured trade creditors and the secured trade creditors of the vendor, setting out the indebtedness or liability due, owing, payable or to become due and payable by the vendor to each of them, and the nature of any security interest: and

(b) an affidavit verifying that subparagraph (i) is true and correct.

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45 *BSA Ontario; Bulk Sales Act,* R.S.N.B. 1973, c. B-9; Bulk Sales Act, R.S.N. 1990, c. B-11.
46 BSA, s.1.
47 Ibid.
48 Ibid.

From and after delivery of the above statement, no creditor of the vendor may obtain a preference or priority in respect of the stock in bulk or the proceeds from the sale thereof.[49]

Compliance

In addition to the requirements set out above, one of the following conditions must be met before the purchaser may deliver proceeds of sale to the vendor:

(i) the statement of indebtedness must not disclose total claims in excess of $2,500 by either the secured trade creditors or the unsecured trade creditors (section 8(1)(a)); or

(ii) the vendor must swear an affidavit stating that the claims of all the secured and unsecured trade creditors of the vendor of which the buyer has notice have been paid in full (section 8(1)(b)); or

(iii) adequate provision must be made for the immediate payment in full upon completion of the sale of all unsecured and secured trade creditors except for any creditor that has signed a waiver allowing the sale to proceed without provision being made to pay its claim in full (section 8(1)(c)); or

(iv) the vendor may deliver to the buyer:

(A) a consent from sixty percent (60%) of the unsecured trade creditors of the vendor whose claims exceed $50, and of whose claims the buyer has notice; and

(B) an affidavit (of the vendor) deposing that the vendor delivered or caused to be delivered to all secured trade creditors and all unsecured trade creditors, personally or by registered mail, 14 days prior to completion of the sale, a copy of the contract of the sale in bulk, the section 4 statement of indebtedness, a Statement of Affairs summarizing assets, liabilities and contingent liabilities included in the sale in bulk and further deposition that there has not been a material change in the Statement of Affairs since it was made.[50]

Duplicate originals of the documents mentioned in subparagraph 3(b)(iv) must be attached as exhibits to the affidavit.

If one of the conditions outlined in subparagraphs (i), (ii) and (iii) above is met, the buyer may deliver the proceeds of sale to the vendor. If the condition in subparagraph (iv) above is met, the buyer must deliver the proceeds of sale to the person named as trustee in the form of consent, who must then distribute the proceeds of sale among the creditors in an order of priority similar to that which applies to a distribution under the BIA.

[49] BSA, s.5.
[50] BSA, s.8.

Before distribution, the trustee must publish a notice in at least two issues of a newspaper, in the locality where the sale is to take place. In addition, the trustee must wait a minimum of 14 days after last publication before distributing the proceeds of sale.

Completion of Sale

The buyer must file, within five days of the completion of sale, an affidavit setting out the particulars of sale including the subject matter, name and address of any trustee, duplicate originals of the statement of indebtedness, and any statement provided under section 8 including creditors' consents. The affidavit shall be filed with the office of the local registrar of the court.[51] The six month time limitation for initiating actions to set aside or have the bulk sale declared void commences as at the date of filing of the affidavit.[52]

Alternatively, compliance in Ontario may be satisfied by the vendor applying to a judge for an order exempting the sale in bulk from the application of the BSA. The Court must be satisfied that the sale is advantageous to the seller and will not impair the seller's ability to pay creditors in full.[53]

4.8.3 Meaning of "Creditor" under the BSA

A "creditor" is defined under the BSA as "any creditor, including an unsecured trade creditor and a secured trade creditor". An "unsecured trade creditor" is defined as "a person to whom a seller is indebted for stock, money or services furnished or for the purpose of enabling the seller to carry on a business, whether or not the debt is due, and who holds no security or who is entitled to no preference in respect of a claim". A "secured trade creditor" is defined under the BSA as "a person to whom a seller is indebted whether or not the debt is due (a) for stock, money or services furnished for the purpose of enabling the seller to carry on business; or (b) for rental of premises in or from which the seller carries on business, and who holds security or is entitled to a preference in respect of a claim". Given the circular definition of the term "creditor" under the BSA, an analysis of the judicial interpretation of the term is necessary.

In *Pizzolati & Chittaro Manufacturing Co. Ltd. v. May*[54], the Ontario Court of Appeal held that a person with an unliquidated claim for damages does not fall within the scope of the term "creditor" as that term is used in the BSA. The Court emphasized that the wording in the BSA and the requisite forms were not sufficient to change the common law definition of the term "creditor" under which unliquidated claims were clearly not included. The Court in Pizzolati also explained that the definition of the term "creditor" under the BSA is dissimilar from that under the BIA, which clearly defined "creditor" as including a person with an unliquidated claim.[55]

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[51] BSA, s.11.
[52] BSA, s.19.
[53] BSA, s.3.
[54] [1972] 2 O.R. 606 (C.A.).
[55] See also *Gordon v. Assegai Inc.,* [1989] O.J. No. 556 (H.C.J.)

4.8.4 A sale in bulk is voidable unless the buyer has complied with the provisions of the BSA. An action or proceeding to set aside or have a sale in bulk declared void may be brought or taken by a "creditor" of the seller within 6 months after the date in which the documents were filed under section 11 of the BSA. If a sale in bulk has been set aside or declared void and the buyer has received or taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof, including all money, security and property realized or taken by the buyer from, out of, or on account of, the sale or other disposition by the buyer of the stock in bulk.[56] In layman's terms, and assuming that the value of the assets being sold is paid by the purchaser at first instance but the sale is not in compliance with the BSA, the worst that can happen under the BSA is that the purchaser is effectively required to pay for the assets a second time.[57]

In the recent decision of *National Trust Co. v. H&R Block Canada Inc.*, the Supreme Court of Canada held that where there is an asset sale that is not in compliance with the BSA, the Court retains the discretion to consider all of the facts of the case to determine what, if anything, should be done to put the unpaid creditors in the position they would have been in had the BSA been complied with or whether a strict liability to pay, under section 16(2) of the BSA, would lead to an unfair result.[58] The Supreme Court commented that a creditor should not be placed in a better position than it would have been in had the buyer complied with the BSA; conversely, the non-compliant buyer should not be unduly punished. The Court held that a pragmatic accounting should take into account proper payments to priority-ranking creditors made as a direct result of payment to the seller of the bulk goods.

Subsection 17(1) of the BSA provides that an action to set aside or have declared void a bulk sale may be brought or taken by a creditor of the seller and, if the seller is bankrupt, by the trustee in bankruptcy of the seller's estate.

4.8.5 Limitation Periods

Section 19 of the BSA provides:

> No action shall be brought or proceeding taken to set aside or have declared void a sale in bulk for failure to comply with this Act unless the action is brought or the proceeding is taken either before the buyer complies with section 11 or within six months after the buyer complies with section 11.

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56 BSA, s. 16(2).
57 BSA, s. 16.
58 [2003] 3 S.C.R. 160.

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Introduction

5.1.1 In the event of a company going into bankruptcy, the authority and powers of the directors are superseded following such an appointment and taken over by the trustee. Consequently, in most cases it is the trustee who has the power to bring actions, but there are a few exceptions to this rule by which an action may be brought by creditors or others directly.

5.1.2 The primary exception to this general rule is with respect to criminal proceedings which have been set out in Question 2 above. All criminal proceedings are handled by the Crown prosecutor.

5.2 Criminal proceedings

5.2.1 The acts set out in section 2.3.2 herein are criminal offences in which the Crown prosecutor may bring an action against the directors and others involved. The trustee in bankruptcy of a company is under a duty to bring any such offences to the attention of the Superintendent of Bankruptcy who will, in turn, deal with the appropriate authority.

5.3 Civil proceedings

5.3.1 The trustee in bankruptcy is the party who will bring proceedings such as reviewable transactions, fraudulent preferences, settlements, and fraudulent conveyances.

5.3.2 With respect to the oppression remedy, the situation is somewhat uncertain. A creditor may be entitled to seek relief under the oppression remedy as a "complainant". A "complainant" is defined to include a "registered holder or beneficial owner, and a former registered holder or beneficial owner of a security of a corporation or any of its affiliates", "a director or officer" and "any other person who, in the discretion of a court, is a proper person to make an application". Under both the OBCA and the CBCA, the term "security" includes a "debt obligation" and therefore the beneficial holder of a debt instrument qualifies as a complainant.[59]

[59] CBCA, s. 241 and 248; and OBCA, s. 245 and 248.

5.3.3 The courts have held that a creditor may be a “proper person” for the purposes of the oppression remedy.

5.3.4 There is conflicting case law on the issue of whether or not a trustee in bankruptcy can assert the oppression remedy on behalf of creditors. The argument in favour of allowing the trustee to be a proper person is that the trustee is the representative of the creditors of the bankrupt estate and has all the causes of action of the bankrupt. However, the contrary position states that the trustee in bankruptcy takes the property of the bankrupt as he finds it and that, subject to statutory provisions such as those dealing with fraudulent preferences and settlements, the trustee only obtains the rights of the bankrupt and no more. If a transaction was approved by the directors of the bankrupt, it follows that the bankrupt itself cannot complain that the conduct of the other contracting parties was oppressive. The rationale is that the transaction can be reviewed under the BIA and therefore the trustee has an adequate remedy.

In a recent decision, the Ontario Court of Appeal held that given the purpose and clear language of the oppression provisions in the OBCA, where a bankrupt is a party to an allegedly oppressive transaction, the trustee is neither automatically barred from being a complainant nor automatically entitled to that status, rather it is for the judge at first instance to determine in the exercise of his discretion whether in the circumstances of the particular case, the trustee is a proper person to be a complainant.[60]

5.4 Other

5.4.1 Although it is beyond the scope of this study, directors are also liable to ensure that certain statutory trust deductions from employee wages are remitted to the government taxing authorities. These trusts include income tax, pension plan contributions and employment insurance. Liability also exists for goods and services tax and provincial sales tax and others. Governments have enforcement mechanisms against directors.

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60 *Olympia & York Developments Ltd*. (Trustee of) v *Olympia & York Realty Corp*. (2004), 46 C.B.R. (4th) 313 (Ont. C.A.).

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

OFFENCE	REMEDY AVAILABLE
BIA General	Where a person has suffered a loss or damage as a result of an offence committed under the BIA, the court may order the person convicted to pay to the victim or to the trustee of the bankrupt estate an amount by way of satisfaction or compensation for the loss of or damage to property.
Reviewable Transaction	In the case when the court finds that the bankrupt entered into a non-arms' length transaction and the consideration was conspicuously greater or less than the fair market value of the goods or services contracted for, than the court may order that the other party to the transaction pay to the trustee the difference between the consideration actually paid and the fair market value.
Fraudulent Preference	When the court holds that a transaction is a fraudulent preference, then the transaction is void as against the trustee. The trustee has the right to recover the property of the bankrupt given to the creditor as consideration for the transaction.
Settlement	When the court holds that the transaction is a settlement, then the transaction is void as against the trustee. The trustee has the right to recover the property or proceeds.
Fraudulent Conveyance	When the court holds that the transaction is a fraudulent conveyance then the transaction is void as against the trustee. The trustee has a right to recover the property that was transferred or the proceeds resulting therefrom.
Declared Dividends	Where a corporation that is bankrupt has paid a dividend at a time when the corporation was insolvent or the payment of the dividend rendered the corporation insolvent, the court may grant judgment to the trustee against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest thereon that has not been paid to the corporation.
Bulk Sales Legislation	A sale in bulk is voidable unless the buyer has complied with the provisions of the BSA. If a sale in bulk has been set aside or declared void and the buyer has taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof.
Oppressive Conduct	Where a corporation acts in a manner that is oppressive to a creditor, a court can make any one of a number of orders as set out in Section 2.7.3.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(a) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations?

7.1 Obligation to co-operate with investigation into company's affairs

7.1.1 Where a bankrupt is a corporation, the officer executing the assignment, or such (a) officer of the corporation; or (b) person who has, or has had, directly or indirectly, control of the corporation as the official receiver may specify, shall attend before the official receiver for examination and shall perform all of the duties imposed on a bankrupt by s. 158, and, in case of failure to do so, the officer or person is punishable as though that officer or person were the bankrupt.

7.1.2 Subsections 16(3) to 17(2) set out the duties and powers of the trustee in obtaining possession of the property of the bankrupt. Section 158 of the BIA imposes 18 duties on a bankrupt including:

(a) informing the trustee of all property that is under his/her possession or control and delivering it to the trustee;

(b) delivery to the trustee of all books, records, documents, writings and papers relating to the property or affairs of the bankrupt;

(c) attending before the official receiver for examination under oath with respect to the conduct of the corporation, the causes of the bankruptcy and the disposition of property;

(d) preparing and submitting to the trustee a statement of the bankrupt's affairs;

(e) making or giving all the assistance within his power to the trustee and making an inventory of assets;

(f) making disclosure to the trustee of all property disposed of within the period beginning on the day that is 1 year before the date of the initial bankruptcy event or such other date as the court may direct;

(g) making disclosure to the trustee of all property disposed of by gift or settlement without adequate valuable consideration in the 5 year period prior to the bankruptcy;

(h) attending the first meeting of creditors;

(i) when required, attending other meetings of creditors or of the inspectors or attend on the trustee;

(j) submitting to such other examinations under oath with respect to property as may be required;

(k) aiding to the utmost of his power, in the realization of the property and the distribution of proceeds among creditors;

(l) executing such powers of attorneys, conveyances, deeds and instruments as may be required;

(m) examining the correctness of all proofs of claim filed, if required by the trustee;

(n) in the case of any person that to his knowledge has filed a false claim, disclosing that fact to the trustee;

(o) doing such acts or things in relation to his property in the distribution of the proceeds among his creditor as may be reasonably required for the trustee.[61]

7.1.3 By subsection 198(2) of the BIA, it is an offence for the bankrupt, without reasonable cause, to fail to perform the duties imposed by section 158.

7.1.4 Under an examination, a witness may claim the protection of section 5(2) of the *Canada Evidence Act*. This section does not permit the witness to avoid answering any questions on the basis that they may be self incriminating, but it does provide protection against self incrimination since the witness' answers cannot be used in any other criminal proceedings thereafter.

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[61] BIA, s. 158.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against the directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 BIA

8.1.1 The limitation period for bringing an action against the director for any offence punishable by way of indictment is 5 years from the commission of the offence. If the offence is punishable by way of summary conviction, then the limitation period is 3 years from the commission of the offence.[62]

8.2 Limitation Period for Civil Actions

8.2.1 In relation to any liabilities created by the BIA or in relation to breaches of directors' fiduciary duties, the limitation period, in provinces other than Ontario, is generally 6 years from the date on which the cause of action accrued. In Ontario, the limitation period is two years from the date on which the claim was discovered.

8.3 Is an appeal available from the decision of the lower courts?

8.3.1 The courts of appeal are given the power and jurisdiction to hear and determine appeals from the Bankruptcy Court. An appeal will only be available, however, in the following cases:

(a) if the point and issue involves future legal rights;

(b) if the order or decision is likely to affect other causes of a similar nature in the bankruptcy proceedings;

(c) if the property involved in the appeal exceeds $10,000 in value;

(d) from the grant or refusal to grant discharge if the aggregate unpaid claims of the creditors exceed $500;

(e) in any other case, by leave of a judge of the Court of Appeal.[63]

8.3.2 An appeal from the decision of the Court of Appeal is only available with special leave granted by the Supreme Court of Canada.

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[62] *Can. (A.G.) v. Hamelin* (1986), 62 C.B.R. (N.S.) 96 (Ont. S.C.).
[63] BIA, s. 193.

8.3.3 The courts of appeal are given the power and jurisdiction to hear and determine appeals from convictions and sentences in criminal matters. Such appeals must be filed within 30 days from the initial decision. An appeal will only be available in an indictable matter:

(a) against a conviction;

(i) on a question of law alone;

(ii) on a question of fact or a question of mixed fact and law with leave of the Court of Appeal; or

(iii) on any other ground with leave of the Court of Appeal; or

(b) against a sentence with leave of the Court of Appeal, unless the sentence is one fixed by law.[64]

An appeal is available in summary conviction matters as of right with no leave requirements.[65]

QUESTION 9

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9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Introduction

9.1.1 The legal provisions and procedures outlined in the BIA apply to individuals and corporations. The BIA defines a corporation as including any "incorporated company, wherever incorporated, that is authorized to carry on business in Canada or that has an office or property in Canada". Banks, authorized foreign banks within the meaning of section 2 of the Bank Act, insurance companies, trust companies, loan companies and railway companies are excluded from the BIA.

9.1.2 In general, all the provisions of the BIA and CCAA relating to the administration of a Canadian company will apply equally to the administration of a foreign company.

9.2 Jurisdiction of Canadian Courts

9.2.1 If no foreign proceeding has been taken against the debtor, all the property of the bankrupt, both moveable and immoveable, vests in the trustee in bankruptcy when bankruptcy occurs. To obtain possession, the trustee may

[64] Criminal Code R.S.C. 1985 c. C-46, as amended, s. 675(1).
[65] Criminal Code, s. 813(a).

have to comply with the formal requirements of the law of the jurisdiction where the property is located, but legal title is conferred on the trustee by the BIA.

The BIA provides no specific criteria which will allow Canadian Courts to administer a foreign company. The Courts have developed a general test whereby they must find a sufficient connection with the local jurisdiction which may, but does not necessarily have to, consist of assets within the jurisdiction of the Court.

9.2.2 The Court may seek the aid and assistance of a court, tribunal or other authority in a foreign proceeding by order or written request or otherwise as the Court considers appropriate.[66]

9.2.3 A foreign representative is defined in the BIA and the CCAA as meaning a person, other then a debtor, holding office under the law of a jurisdiction outside Canada who, irrespective of the person's designation, is assigned, under the laws of the jurisdiction outside Canada, functions in connection with a foreign proceeding that are similar to those performed by a trustee, liquidator, administrator or receiver appointed by the court. Under the BIA, a foreign representative may commence and continue a proceeding for a receiving order, interim receiver and for a proposal in respect of a debtor as if the foreign representative were a creditor, trustee, liquidator or receiver of property of the debtor, or the debtor as the case may be.[67]

9.2.4 As noted in paragraph 9.1.2 above, the general principle is that following a receiving order being made against a foreign company, all the provisions of the BIA will apply in the same way as for a Canadian company.

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 Directors' liability insurance is available in Canada.

Generally, the coverage that is available to the directors will cover amounts that the directors are legally required to pay as a result of any claim brought against them as a result of wrongful acts, and includes damages, judgments, settlements and defence costs, but excludes fines, penalties, punitive and exemplary damages and any other charges deemed uninsurable. Generally,

[66] BIA, s. 271(1); CCAA, s.18.6(6).
[67] BIA, s. 267 and 270.

the coverage will also provide for reimbursement of the costs of a successful defence of penal charges brought in Canada against the directors.

In order to obtain this type of insurance, the directors and its officers must certify that specific standards are met in the operations regarding environmental issues and that the company does not, at the time of requesting the policy, have any exposure to the directors of the organization.

In addition, it is easier to obtain directors insurance for directors of the board who are not involved in the day to day operations of the business than for directors involved in the day to day operations of the business and in the decision making.

10.2 The standard exclusions in the directors' and officers' liability insurance can be grouped into three broad categories:

(a) Those relating to exposures deemed uninsurable, such as:

- Illegal personal profits or gains;
- Reimbursement of illegally paid remuneration;
- Profits or gains realized due to insider information; and
- Dishonest acts – except defence costs.

(b) Those relating to risks which are to be covered under other policies or for which no insurance is available, such as:

- Claims covered by other director's and officer's policies, except for amounts exceeding the amounts covered by those policies;
- Claims related directly or indirectly to pollution;
- Bodily injury or property damage;
- Failure to maintain insurance;
- Claims related to employee pension or welfare benefit plans; and
- Nuclear incidents.

(c) Those which are specific to the nature and purpose of directors' and officers' policies, such as:

- Pending or prior litigation;
- Circumstances known at the time the policy came into effect;
- Claims made by an organization or on its behalf;
- Claims made by directors or officers, except wrongful dismissal by former officers;

- Wrongful acts committed before the company became a subsidiary of the organization; and

- Service on the Board of Directors of companies other than the insured company or its subsidiaries.

10.3 Prior to obtaining any directors' and officers' insurance coverage the insurance company will require that:

(a) The company's treasurer certifies that the following have been addressed and are being dealt with within the corporation:

- That the company is not in arrears in the payment of wages, benefits, valuation or any form of compensation;

- That there are no outstanding claims made by any employee or former employee of the organization for unpaid compensation;

- The organization is not in arrears in either withholding or remitting to the government agency any amount required to withhold and remit under the following statutes:

- *Income Tax Act*;

- Provincial Taxation Act (which is applicable to a specific location of the company);

- *Canada Pension Plan (Canada);*

- *Unemployment Insurance Act (Canada);*

- Ontario Health Insurance Plan;

- *Act respecting Occupational Health and Safety*;

- *Excise Tax Act (Canada) including Goods & Services Tax*;

- *Pension Benefits Act, 1987*; and

- Any other statute, regulation, order, judgment, decree or official directive of a government body, whether or not having a force of law, under which failure to withhold and remit such sums would give rise to a claim against the directors of the organization.

(b) Directors and Officers involved with environmental compliance must certify that the following issues have been dealt with or are not occurring in order to obtain insurance:

- Employees are trained to handle waste and hazardous material and that they complied with the environmental laws;

- That there have not been spills, releases, deposits, emissions or discharge of any contaminated materials, waste or hazardous materials except for (must advise of any issues); and that any such spills have been reported and remedied in substantial compliance with all applicable environmental laws;

- The organization has obtained all necessary and required permits, licenses, and certificates of approval required for its operations under any applicable environmental laws;

- All waste generated by operations or the organization has been delivered to licensed waste removers and disposed with licensed waste disposal firms as required with the environmental laws; and

- The organization has not been subjected to any order, direction, notice of defaults, warrants or any pending order in relation to a violation or alleged violation of any applicable environmental law.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 The details of directors' duties are considered above at question 2. There is a fiduciary relationship between the directors and the company and two primary fiduciary duties of directors are recognized, namely, a duty of care and a duty of loyalty.

Firstly, with respect to the duty of care, directors must act in an informed and considered manner. Directors should review all material information available to them and, with this information in mind, act with "requisite care". In Canada, this duty is codified in corporate statutes requiring directors to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

In the event of insolvency, even outside of a formal bankruptcy, directors of an insolvent corporation continue to owe their duties to the corporation. See the discussion of this issue in sections 2.2.2 and 2.2.3.

Directors must also be cognisant of the oppression remedy codified in corporate statutes. The courts are in a position to grant appropriate remedies if the powers of the directors are exercised in a manner that is oppressive, unfairly prejudicial to or unfairly disregards the interests of any security holder, creditor, director or officer. This remedy is available whether the company is solvent or insolvent. However, the potential for action to have an adverse impact on creditors and other stakeholders may be enhanced when the company is insolvent. In light of the possibility of an oppression remedy, directors must carefully consider the impact of any action on creditors and other stakeholders.

11.2 Business Judgment Rule

In the United States, the business judgment rule is the directors' primary protection. It is a presumption that, in making any decision, the directors acted on an informed basis, in good faith and in the honest belief that the decision was in the best interests of the corporation. In Canada, if directors follow appropriate procedures and act honestly, in good faith and in the best interests of the corporation in making decisions, courts generally will not second-guess the board's judgment, even if the judgment ultimately turns out to be wrong in hindsight.

11.3 Directors should act in accordance with the business judgment rule. They should avoid actual conflicts of interest, avoid preferential treatment of certain constituencies, disclose all potential director contacts or relationships that could create even an appearance of a conflict of interest, and they should act only with the requisite information and due deliberation.

In addition, directors should ensure that their actions meet the "fairness test". The demonstrable "fairness" of an action will provide protection if the business judgment rule is not applicable.

Directors should obtain advice of outside professionals for any significant board action, including advice regarding the application of fiduciary duties and alternatives to the proposed course of action.

Finally, directors should ensure that there is adequate support for their decisions, such as reports of officers or outside advisers, which should be obtained and then reviewed by the board and reflected in the records of the board's deliberations.

11.4 It should be noted that in a decision of the Ontario Court of Appeal, the Court held an officer personally liable for "inducing" a bank to extend credit to a company when it was in financial difficulty.[68] On balance, during the twilight period, further or additional credit should only be incurred if there is a reasonable probability that the debt can be satisfied.

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[68] *NBD Bank, Canada v. Dofasco Inc*. (2000), 46 O.R. (3d) 514 (C.A.).

APPENDIX

Summary of Canadian bankruptcy and insolvency law

Introduction

Canada and the United States are two of the world's largest trading partners. As a result, it continues to be important for lawyers and businesspeople on each side of the border to be aware of the other country's insolvency and reorganization regimes. The United States has, for some time now, had a comprehensive and generally effective reorganization scheme under Chapter 11 of the U.S. Bankruptcy Code. As a result of amendments in 1992 and 1997, Canadian reorganizations can now be effected under two regimes: the *Companies' Creditors Arrangement Act* ("CCAA") and the *Bankruptcy and Insolvency Act* (the "BIA").

Debt Recovery

Before embarking upon a discussion of reorganizations and insolvency laws in Canada, we must first consider issues pertaining to the recovery of debts and the enforcement of security by lenders.

Types of Financing

The two basic types of financing are secured and unsecured. Unsecured financings are generally governed by the contractual terms on which the loans were made. The law of contract is a matter of provincial law under the Canadian constitution. As is the case in most common law jurisdictions, except in very specific situations (e.g. mareva injunctions), there is no execution before judgment. What this means is that an unsecured creditor who is owed money and not paid must commence legal proceedings and obtain judgment. It is only after judgment is obtained that the assets of the debtor may be seized and sold to satisfy the debt. This can be a very slow and costly process.

Security may be taken against either personal property or real property. The interpretation of security agreements and their enforcement are, in general, matters of provincial law in Canada. The primary exception is "Bank Act security" under section 427 of the Canadian Bank Act, which is available only to banking institutions (as opposed to other lending institutions), and which is, essentially, only available to secure an interest in the debtor's inventory and receivables.

Real estate security is governed by provincial mortgage lending statutes, which regulate both the way in which such security is taken and the way in which it is enforced. In most common law provinces including Ontario (Quebec is a civil law jurisdiction), security against personal property is governed by the particular province's Personal Property Security Act ("PPSA"). The PPSA is legislation modeled substantially on Article 9 of the Uniform Commercial Code. As with Article 9 of the UCC, PPSA legislation governs the taking, perfection, priority and enforcement of security in the particular province.

Enforcement of Security

Section 244 of the BIA provides that a secured creditor which intends to enforce its security on all or substantially all of the inventory, accounts receivable or other property of an insolvent person used in relation to its business, must send the insolvent person a notice of its intention in a prescribed form and manner. The secured creditor is then prohibited from enforcing its security for 10 days after sending the notice, unless the insolvent person consents to earlier enforcement. The BIA further provides that the insolvent person may not consent to a shorter time period prior to the issuing of a notice. Therefore, a secured creditor may not attempt to have the debtor contractually waive this requirement prior to the issuance of the notice.

A secured creditor may apply to court to appoint an interim receiver during the 10 day period or even before it starts to run if the creditor can satisfy the judge that it is necessary to protect the debtor's estate or the interests of the secured creditor.

Once section 244 of the BIA has been complied with, there are a number of ways for secured creditors to enforce their security.

Self-Help

In PPSA jurisdictions, upon default under a security agreement (including all forms of secured financings), a secured creditor is entitled to exercise self-help remedies and take possession of the collateral. Where appropriate, possession may also be taken by rendering the collateral unusable. A secured creditor who has taken possession generally has the right, upon certain notice provisions being complied with to either sell the collateral (by private or public sale, so long as it is commercially reasonable), to recover the indebtedness, or to foreclose and take the collateral in satisfaction of the debt. However, should the debtor or others with an interest in the collateral object to a foreclosure, the secured creditor will be required to sell the collateral. Exercising foreclosure extinguishes the debt and prevents recovery of any deficiency, whereas the sale process does not.

Appointment of Receiver

Where provided for in the security agreement, a secured creditor may have the right to appoint a private receiver or receiver and manager to take possession of and realize upon the collateral on behalf of the secured creditor. This is often done where the secured creditor desires the assistance of an accounting firm to act as its agent to commence the realization process.

A secured creditor also has the right to seek the appointment of a court-appointed receiver or receiver and manager to assist in the enforcement or realization process. This remedy is usually used where difficulty is expected in exercising self-help remedies or appointing a private receiver, or where the secured party wishes to obtain the protection of a court appointment. As a result of the court's involvement, this process is generally slower and more costly, but does allow the secured creditor to have its enforcement and realization process approved by the court so as to minimize the risk of criticism or lender liability issues.

Liquidation

The liquidation of most businesses in Canada is conducted under the BIA. Upon the bankruptcy of a debtor, whether voluntarily or upon the petition of a creditor, the BIA imposes a stay of proceedings in respect of the debtor. In the liquidation context, the stay of proceedings does not generally apply to secured creditors (the scope of the stay of proceedings in a Proposal under the BIA is discussed below), who are free to exercise their rights of self-help or to otherwise realize on their security outside of the BIA. There is one exception to this rule, which has been guarded jealously by

Canadian Bankruptcy Courts. Upon the application of the debtor, the Bankruptcy Court may, in exceptional cases, stay the rights of a secured creditor for up to six months. For the most part, however, upon bankruptcy, secured creditors may proceed to realize upon their collateral with impunity.

Reorganizations

As with Chapter 11 of the U.S. Code, the purpose of Canadian reorganization laws is to allow a financially troubled business to remain in possession of its assets and restructure its affairs under the court's supervision so as to avoid liquidation and the consequent loss of jobs and goodwill. The two primary statutory options for reorganizing a financially troubled business in Canada are the CCAA and Proposals under the BIA.

CCAA

Generally

The CCAA is a federal statute which was enacted in the 1930s, but which has become a favourite refuge of Canadian companies in financial difficulty. Its popularity is largely due to the fact that, unlike the pre-1992 Canadian Bankruptcy Act, the CCAA can be used to stay non-creditors, secured creditors and unsecured creditors while restructuring the company's secured and unsecured debt. The practical aspects of a CCAA proceeding are, after its commencement, similar to Chapter 11 proceedings. In fact, the CCAA might be thought of as Chapter 11 without legislative rules.

Procedure

CCAA proceedings are commenced by the issuance of a court order upon an application brought by either the debtor or its creditors. Most often the debtor brings the application itself. Generally, the application seeks:

- a declaration from the court that the debtor is a corporation to which the CCAA applies;
- an order that the debtor file a plan of arrangement within a certain time frame and hold meetings of classes of creditors; and
- an interim stay of all actions, suits and other proceedings against the debtor.
- A debtor will be a corporation to which the CCAA applies if:
- it is a Canadian company, has assets in Canada or carries on business in Canada;
- it is insolvent or has committed an act of bankruptcy (a defined term in the BIA); and
- it has outstanding indebtedness in excess of $5 million.

Stay of Proceedings

The most attractive feature of CCAA protection, from a debtor's perspective, is probably the discretion given to the court in granting a stay of proceedings. The CCAA permits the court to order a stay of proceedings, which generally will be imposed against all creditors, secured and unsecured, landlords and other persons who are not creditors of the company, to prevent them from exercising contractual rights which would make it difficult, if not impossible, for the company to proceed with its reorganization. Due to this discretion and the fact that the debtor brings the application, there is flexibility to "tailor" the stay to the particular circumstances of the case.

CCAA proceedings are commenced in the courts of one province only. Since the CCAA does not itself impose the stay of proceedings, the court's initial order generally requests the assistance of courts in other jurisdictions, including the U.S., to enforce its terms.

Initial Order

The CCAA provides that the initial stay of proceeding can only be for 30 days, after which extensions are in the discretion of the court on notice to interested parties.

Monitor

Although it is the exception rather than the rule for a trustee or monitor to be appointed in a Chapter 11 bankruptcy in the United States, it is a legislative requirement in CCAA proceedings for the court to appoint a monitor to supervise and assist in the preparation of financial information regarding the debtor and the plan of arrangement itself. Generally, the monitor is one of the major accounting firms, whose role is also to report to the court and the creditors on the company's activities and to ensure that the relative positions of the creditors remain the same pending voting and approval of the plan.

DIP Financing

Unlike 11 U.S.C. § 364, there is no statutory provision in Canada which addresses the subject of the debtor obtaining credit during a reorganization. DIP financing has been authorized by the courts, but in most cases with the consent of secured creditors affected by such financing. Judges have, however, using their inherent jurisdiction, authorized the use of DIP financing in CCAA cases. To a limited extent, the Court has allowed the security given to DIP lenders to rank prior to that of other secured creditors. Views regarding the permitted use of DIP financing in BIA proposals has been mixed.

The 2003 Report of the Standing Senate Committee on Banking, Trade and Commerce recommended that the BIA and CCAA be amended to permit DIP financing. The recommendations included (i) the Court should be given the jurisdiction to allow the lien given by the DIP lender to rank prior to such other existing security interests as it may specify; (ii) any secured creditor affected by such priority should be given notice of the Court hearing intended to authorize the creation of security ranking prior to its security; and (iii) in deciding whether to authorize a DIP loan, the Court should be required to consider several factors.

Classes of Creditors

In the course of preparing the plan of arrangement, the debtor must separate its creditors into classes according to their interests. Generally, those creditors with similar economic interests (a “commonality of interest”) are grouped together into a class. Often, there is one large class of unsecured creditors and a few classes of secured, depending upon issues such as the type of security held and its priority. However, it is possible for creditors to be included in more than one class in respect of any specific debt, particularly with respect to secured creditors who have under-secured exposure. As with Chapter 11 proceedings, the classification of creditors is essential to the success of any CCAA plan.

Once the plan has been finalized, formal meetings of the creditor classes are held to vote on the plan. The corporation generally distributes an information circular with the notice of meeting to all creditors who will be affected by the plan. Information circulars contain details of the company’s financial condition, an explanation of the plan and its effects on the creditors and an estimate of the liquidation value of the company’s assets.

The general consensus among Canadian practitioners is that, in most cases, the plan must be accepted by the requisite statutory majority of each class of creditors in order to be sanctioned by the court. The statutory majority for each class of creditors is a majority in number and two-thirds in value of the claims of that class present and voting in person or by proxy.

Court Sanction

If the statutory majority of any class approves the plan and the plan is sanctioned by the court, every creditor in that class will be bound by the plan. Once approved by the requisite majority of creditors, the plan must be sanctioned by the court before it can be effective. The court will only sanction the plan if it is satisfied that the plan is fair and reasonable. Once this has been done, the plan is binding on all classes of creditors who have accepted the plan, as if it were a contract between the debtor and those creditors.

The primary advantages of the CCAA include the ability to obtain a broadly worded stay order and the flexibility accorded the debtor by the lack of a comprehensive legislative framework.

There are, however, disadvantages to this procedure. First, there is no certainty that relief will be granted; relief is completely in the discretion of the court and there are precedents for the rejection of applications on a number of grounds, both technical and substantive. In addition, due to the high level of court supervision and the lack of a specific statutory framework, the costs incurred in a CCAA reorganization can be prohibitive.

Proposals Under The BIA

Since 1949, Canadian bankruptcy legislation has contained proposal provisions to enable troubled companies to reorganize their affairs. However, prior to 1992, those proposal provisions were only binding upon unsecured creditors. Therefore, unless the debtor was able to obtain the cooperation of its secured creditors, it could not effectively reorganize its affairs under that legislation. However, by its application to secured creditors, Part III of the BIA has established an effective legislative framework for reorganization in Canada in which judicial participation is encouraged to balance the rights of creditors in general and the debtor's opportunity to reorganize.

Commercial Reorganizations

Commercial reorganizations under the BIA are conducted by way of "Proposals", which may be made by an "insolvent person", a receiver, a liquidator, a bankrupt or the trustee of the bankrupt's estate. By definition, an "insolvent person" includes all forms of business entities and, therefore, the BIA's proposal provisions are not restricted to corporate entities. Unlike Chapter 11 reorganizations, a proposal under the BIA must name a licensed trustee in bankruptcy to act as trustee under the proposal. The trustee under a proposal has a number of legislatively mandated duties and responsibilities in respect of the debtor and the proposal itself, including assisting with the preparation of financial information regarding the debtor and reporting to both the court and creditors. A proposal is initiated when it is filed with the Official Receiver, the federal government appointee responsible for administering the BIA.

Proposals under the BIA may be made to creditors generally or to classes of creditors, both secured and unsecured. Proposals under the BIA may specifically deal with those secured creditors which the debtor wishes, in some way, to compromise; provided that, where a proposal is made to secured creditors in a particular class, the proposal must be made to all secured creditors in that class.

Unlike Chapter 11 filings, proposals may only be initiated by the debtor or a person acting on behalf of the debtor (including the debtor's trustee in bankruptcy). A creditor cannot commence a proposal. Petitions brought by creditors against a debtor under the BIA may only seek its liquidation.

Notice of Intention to File a Proposal

Reorganizations under the BIA are commenced by the debtor filing either a proposal or a notice of intention to file a proposal. A notice of intention is a simple one page statement signed by the debtor and filed with the Official Receiver, and which must include the consent of a trustee in bankruptcy who has agreed to act as trustee under the proposal and a list of all creditors with claims exceeding $250. It is interesting to note that only an "insolvent person" may initiate a reorganization by filing a notice of intention; a bankrupt, trustee, receiver or liquidator is not entitled to do so. Thus, it is clear that the notice of intention provisions are intended to create a procedure for the reorganization of troubled businesses which are not yet subject to bankruptcy or receivership proceedings.

The trustee named in the proposal or the notice of intention is required to notify all known creditors of the filing and, in the case of a proposal, the date of the meeting of creditors to consider the proposal. As well, the debtor must file, and the trustee must verify, cash flow statements in connection with the commencement of a reorganization under the BIA.

In a Chapter 11 reorganization, subject to the discretion of the courts, the debtor has 120 days within which it is the only party which may file a plan and a further 60 days to seek acceptance of that plan by creditors before other parties can propose plans.

Often, six months time is given, as a minimum, to reorganize under Chapter 11. Under the BIA, this is intended to be the maximum time period.

Under the BIA, after filing a notice of intention, the debtor has 30 days to file a proposal with the Official Receiver. However, this 30 day period may be extended, on application to the court, for up to a maximum of 5 additional months, provided that such extensions are solely for the purpose of enabling the debtor to file its proposal and that they may only be granted for periods of up to 45 days at a time. After the proposal has been filed with the Official Receiver, the trustee is required to hold a meeting of creditors within 21 days. The trustee must notify the creditors at least 10 days before the meeting. Therefore, by filing a notice of intention and a proposal under the BIA, and subject to the court's discretion in granting extensions, a debtor may provide itself with a 6 month period within which to formulate and obtain approval for a proposal.

Stay of Proceedings

Perhaps the most important provision of the BIA relating to proposals is the stay of proceedings. As with section 362 of the U.S. Bankruptcy Code, the stay of proceedings arises automatically upon the filing of a notice of intention or a proposal and operates to bind all creditors, secured and unsecured, as well as the federal and provincial governments in respect of their rights of garnishment, etc., for various claims. The stay operates throughout the period from the date of filing of the notice of intention or proposal to the date of court approval and, in respect of those debts caught by the proposal, beyond. In Canadian bankruptcy law, this is a fairly radical concept, since secured creditors are now automatically precluded by statute from relying on clauses in their security agreements which purport to terminate the debtor's ability to deal with the collateral upon insolvency.

There are, however, certain exceptions to the application of this stay. With respect to secured creditors, those who actually took possession of secured assets before the debtor filed its notice of intention or proposal are excluded, as are those who actually gave a notice of intention to enforce their security more than 10 days prior to the debtor's notice of intention or proposal. As well, the stay does not apply to secured creditors who are not included within the debtor's proposal, or who are in a class of secured creditors which has rejected the proposal. In addition, secured creditors have the statutory right to apply to the court to lift the stay of proceedings where they can show that their security position is deteriorating or detrimentally affected by the stay imposed under the proposal.

The stay provisions of the BIA prohibit the termination of contracts entered into between third parties and the debtor. Upon the filing of a notice of intention or proposal, any party to an agreement with the debtor is prohibited from terminating, amending or claiming an accelerated payment under the agreement as a result of the debtor's insolvency, or its filing of a notice of intention or a proposal. With respect to leases, lessors and licensors are precluded from terminating their agreements by reason of pre-filing defaults or arrears in payments. As well, the BIA provides that these prohibitions cannot be waived or varied in advance by contract. However, persons affected by these provisions are entitled to require post-filing payments to be made in cash, and are not required to make further advances of money or credit.

Disclaimer of Commercial Leases

Under previous bankruptcy legislation in Canada, trustees in bankruptcy were able to disclaim leases and thereby terminate lease obligations. However, unlike their U.S. counterparts, prior to 1992 debtors were not able to terminate lease obligations in proposals.

Under the BIA, a debtor who has filed a notice of intention and has determined, in the course of preparing its proposal, that it must reduce its lease obligations, is given the option of disclaiming any one or more of its commercial leases on 30 days written notice to the respective landlords. It is important to note, however, that such a notice may only be delivered between the filing of a notice of intention to make a proposal and the filing of the proposal, or on the filing of a proposal.

In connection with such a disclaimer, the landlord has no claim for accelerated rent (as it might in a bankruptcy) and becomes entitled to file a proof of claim in the proposal. The proposal itself must state whether the landlords with disclaimed leases are to be placed in their own class as creditors or with other unsecured creditors. As well, the proposal must indicate whether the landlords may file a proof of claim for their actual losses as a result of the disclaimer, or for an amount equal to the lesser of (i) the aggregate of the rent under the lease for the next year plus 15% of the rent for the remainder of the term of the lease after that year, and (ii) three years rent under the lease. Of course, the proposal will also detail the compromise which the debtor proposes for such claims.

A landlord may object to a proposed disclaimer by applying to the court for a declaration that the disclaimer does not apply to a particular lease. On such an application, the court must make the declaration unless the debtor satisfies the court that it will be unable to make a viable proposal to its creditors without being able to disclaim all of the leases in question.

Classes of Creditors

In general, all unsecured creditors will be placed in one class. However, there may be circumstances in which there will be more than one class of unsecured creditors. As with the CCAA, secured creditors will generally be included in the same class if their interests are sufficiently similar to give them a “commonality of interest”. The BIA provides criteria to assist in this determination and also grants the court the power to classify creditors.

Due to the flexibility of proposals under the BIA, a debtor may choose to exclude a secured creditor or group of secured creditors from its proposal. Therefore, a debtor is able to select those secured creditors on which it wishes to impose a stay of proceedings.

Voting and Approval

Meetings of creditors to vote on the proposal must be held within 21 days of the filing of the proposal with the Official Receiver. All classes of creditors to which the proposal has been made must vote. However, even if one or more of the classes of secured creditors rejects the proposal, that will not defeat the proposal. Rather, a proposal’s acceptance or rejection is based upon the vote of unsecured creditors. Therefore, a proposal will be accepted if it has the support of a majority in number and two-thirds in value of each class of unsecured creditors who vote in favour of the proposal. Any class of secured creditors which has rejected a proposal accepted by the unsecured creditors will not be bound by that proposal or the stay of proceedings and they may exercise their remedies as they see fit.

If the requisite majorities of unsecured creditors do not approve the proposal, the debtor is automatically deemed bankrupt with effect as of the earlier of the date of filing of the notice of intention, the proposal or the first bankruptcy petition lodged against the debtor. Further, if a debtor defaults in the performance of a proposal and the default is not waived or remedied, the trustee is required to inform all of the creditors and the Superintendent of Bankruptcy. Such default permits creditors to apply to the court to have the debtor placed into bankruptcy immediately.

After acceptance of a proposal by the unsecured creditors, the trustee must apply to the court to have it approved.

It is clear that the Canadian government has taken great strides towards creating an effective and comprehensive reorganization framework under the BIA. It is clear that two of the primary advantages are the broadened stay provisions and the ability to deal adequately with commercial landlords in the framework of a proposal. Among the disadvantages are the fact that failure of a proposal results in automatic bankruptcy, the stay provisions are limited to a period of 6 1/2 months, regardless of the complexity of the matter at hand, and the fact that the requirement to continually return to the court for extensions of the stay period may prove quite costly.

General Provisions

The BIA contains a number of other provisions which have a significant impact on insolvency practice in Canada.

Rights Of Unpaid Suppliers

Section 81.1 of the BIA guarantees the rights of unpaid suppliers to repossess their goods in certain circumstances. Upon the appointment of a receiver over all or substantially all of the assets of the debtor, or upon the debtor’s bankruptcy, suppliers of that debtor may have access to repossess their goods if they present a written demand for repossession to the debtor, the trustee or receiver containing the details of every supply transaction within the 30 day period immediately preceding the demand for repossession. The trustee, receiver or debtor, upon receipt of such demand, must determine whether to admit the claim and, if so, must so notify the supplier. The supplier then has 10 days after receipt of the notice to exercise its rights. If it fails to do so within the 10 day period, those rights will disappear.

The unpaid supplier’s rights extend only to that portion of the goods supplied for which it has not been paid in full. In addition, the right only exists if:

- the goods are in the possession of the debtor, the trustee or the receiver;
- they are identifiable;
- they are in the same state as they were on delivery; and
- they have not been re-sold at arm’s length.
- As well, the right may be extinguished upon payment by the trustee, receiver or debtor of the outstanding balance.

In practical terms, upon the bankruptcy or receivership of a debtor, the receiver or the trustee is required to notify all creditors. A supplier, upon receiving notice of bankruptcy or receivership will issue a written demand for repossession of all goods which they have supplied in the previous 30 days and which have not been fully paid for. Upon receiving such a demand, the debtor, trustee or receiver will review the transaction and determine whether to admit the claim. If so, the trustee, receiver or debtor must respond to the supplier indicating that its claim has been accepted. The supplier then has 10 days to return and repossess, at its own expense, that portion of the goods which remain unpaid for.

The Report of the Standing Senate Committee on Banking Trade and Commerce has recommended that the BIA be amended to repeal, subject to the noted exception, the provisions that provide protection for unpaid suppliers of goods to bankrupt companies. It recommended that the provisions that protect the rights of farmers, fishers and aquaculturalists as suppliers be retained.

Receiver's Duties And Responsibilities

The provisions of the BIA relating to receivers apply to both privately and court-appointed receivers. Part XI of the BIA imposes an obligation on receivers to notify the Superintendent in Bankruptcy and each creditor within 10 days of being appointed. This is a continuing obligation which requires the receiver to provide notice to any additional unsecured creditor of which it becomes aware during its appointment.

In an attempt to increase both the accountability of receivers and supervision of their actions, the BIA requires receivers to prepare and file both interim and final reports and statements of account. Copies of each report must be provided to the Superintendent of Bankruptcy, the debtor and any creditor who requests a copy.

The BIA requires receivers, by statute, to act honestly and in good faith, and to deal with the property of the insolvent person in a commercially reasonable manner. At any time after the receiver takes possession and control of the property, any interested party, including unsecured creditors, may apply to the court to review the receiver's actions. If the court believes that the receiver, the secured creditor or the debtor has not complied with their respective duties, the court may direct them to carry out such duties or preclude the receiver or secured creditor from realizing on any property until the duty has been complied with.

As well, the BIA provides limited protection for receivers in that no action lies against a receiver for loss or damage arising from its reports if they are prepared in good faith and in compliance or intended compliance with the BIA.

Limited Environmental Protection For Receivers and Trustees In Bankruptcy

Environmental liabilities have become a major concern in Canada, both for creditors wishing to realize on security over real property and for receivers and trustees in bankruptcy in agreeing to act. The BIA provides that receivers and trustees in bankruptcy are not personally liable for any environmental damage which occurred either before or after the date of their appointment, unless the damage resulted from the failure of the receiver or the trustee, as the case may be, to exercise due diligence. Receivers and trustees in bankruptcy, however, must still comply with any reporting requirements imposed by environmental legislation at the federal or provincial level.

CHINA

Introduction

It is necessary to have an introductory note before dealing with the questionnaire, since the business and legal environment in China is significantly different from almost all other jurisdictions in the world. Under the so-called socialist market economy, the government has still maintained its control not only over the market development as a policy maker and market regulator, but also over many companies and enterprises as a stake owner. Such conflicting roles of the government have led to defective legislation, lax enforcement and various problems of corporate governance.

Presently, China does not have a uniform business enterprise law. The current framework sees dual-track legislation: on the one line there are enterprise laws that are adopted based on ownership classification, such as State-Owned Enterprises Law (1986), Urban Collective Enterprise Law (1991), Sino-Foreign Equity Joint Venture Law (1979 as amended in 2001), Sino-Foreign Contractual Joint Venture Law (1988 as amended in 2000), and Wholly Foreign Owned Enterprise Law (1986 as amended in 2000). On the other line, Company Law (1993 as amended in 1999), Partnership Enterprise Law (1997) and Sole Proprietorship Enterprise Law (1999) are also introduced into China. As a result, it seems impossible to find consistent rules governing directors' liabilities and to discuss them one by one within this project. Thus, this report will have its primary focus on the provisions of the Company Law and related regulations.

Moreover, the underdevelopment of the legal infrastructure in China has also hindered the modernization of the rules governing directors' liabilities. China enacted its first Enterprise Bankruptcy Law in 1986. But the Law may only be applicable to state-owned enterprises ("SOEs") and a considerable part has proved outdated today. In the Company Law, merely less than 10 articles are set out to deal with company bankruptcy, dissolution and liquidation. Although China has endeavoured to modernize its bankruptcy regime since 1994, the controversies on the technical issues, together with ideological difficulties still subject the enactment to uncertainty[1]. Consequently, both the enterprises and the judiciary have to heavily rely on the government policy and circular as the practical guidance. Further, as a socialist country with a strong civil law tradition, judicial decisions are neither systematically reported, nor followed as precedent. However, some cases are selectively reported in order to remedy the defective regime. As such, these judicial decisions may serve as indicators of development trend.

Against this backdrop, this report is made on the basis of the current law, government decrees, judicial interpretations of the Supreme People's Court, and certain ministry regulations. Despite the defective conditions, it is the authors' hope to reflect the current state of the legal framework in this regard and make a contribution to this world-wide comparative study.

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[1] In 1995 a comprehensive draft of the uniform Bankruptcy Law was completed. However, the unripe social and legal conditions caused the draft to be shelved for a long time. The drafting process only resumed in 1998 and is now continuing. March 2004 saw the completion of a new draft by the drafting group and the enactment has been penciled down on the agenda of the national legislature. As such, it is expected that the draft will be adopted in the near further after some further revision.

QUESTION 1

1. The start and duration of the "twilight" period

Generally Article 35 of SOE Bankruptcy Law allows the avoidance power to be exercised to attack transactions of unfair preference or fraudulent transfer within six months prior to the period from the acceptance of the bankruptcy case by the People's Court. These transactions include concealment or partition of assets of the debtor enterprise, transfer of assets without consideration, sales of assets below reasonable value, provision of security to unsecured debts, payment of pre-mature debts and giving up of the claims that the enterprise may exercise. Article 40 provides that the People's Court shall recover the assets concerned if the unfair preference or fraudulent transfer is discovered within one year of the conclusion of the bankruptcy proceedings. Article 41 further stipulates administrative and even criminal liabilities against the responsible persons for the conducts listed above. These rules may also be applicable to other enterprises by the reference of the Civil Procedure Law of China by the People's Court[2].

However, given the developing stage of the Chinese bankruptcy law, the current rules seem to offer little definition of the "twilight period". The defective corporate as well as the bankruptcy regime has created loopholes for insolvency fraud against the state or other creditors where the state-owned companies or enterprises are left as empty shells after the assets are transferred or pocketed by directors. In China as a transitional economy local government's frequent involvement in bankruptcy proceedings to protect local assets from being taken by creditors of other jurisdictions has further complicated the situation. To combat the fraudulent bankruptcy practice, the State Council in a decree dated March 2, 1997 adopted certain measures, including disqualification of senior officers of a bankrupt SOE and imposition of administrative and even criminal liabilities. It is stated that the legal liability must be affixed once the fraudulent bankruptcy is found[3]. On March 6, 1997 the Supreme People Court echoed the Central Government position by issuing a circular to the lower courts[4]. In particular it is provided in Article 6 that any concealment, partition or transfer of assets of a SOE, either for no consideration or below value, payment of pre-mature debts or giving up of creditor's rights shall be void and the assets concerned shall be recovered if the purpose of the conduct is to evade the debt obligation.

In 2001 the Supreme People's Court issued another emergency notice requiring lower courts to take effective measures to prevent bankruptcy fraud[5]. Article 6, for example, permits a People's Court to avoid any security

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[2] Due to the lack of applicable rules, the Supreme People's Court in a judicial interpretation held that People's Court may make reference to the provisions of the SOE Bankruptcy Law in hearing bankruptcy cases of other types of enterprises. The Opinions of the Supreme People's Court on Issues Concerning Application of Civil Procedure Law of July 14, 1992.

[3] Section 7 of the Supplementary Notice of the State Council on Issues Concerning Mergers and Bankruptcy of State Owned Enterprises in Certain Cities on a Trial Basis and Re-employment of Their Workers of March 2, 1997.

[4] Notice of the Supreme People's Court on Issues of Recent Concerns Concerning Trials of Enterprise Bankruptcy Cases of March 6, 1997.

5 Emergency Notice of the Supreme People's Court Concerning Effective Prevention of Evasion of Debt Obligations by Debtors in Enterprise Bankruptcy and Transformation Proceedings of August 10, 2001.

arrangements if the debtor unfairly creates security interest in favour of one creditor resulting in infringement of lawful rights of others. These new rules, nonetheless, specify no limitation on the time frame. As a result, the avoidance power in these contexts may be exercised beyond the six-month period to attack fraudulent transactions. Hence, the start and end of the “twilight zone” are hardly defined and subject to the government policy guidance and judicial discretion.

The bankruptcy of Haerbin Purchasing Supply Centre in 1995 may serve a good example in this regard. In this case the Supreme People’s Court found that the Centre had withdrawn most of its capital before it applied for bankruptcy of a wholesale market it established. Although the withdrawal took place beyond the reach of the avoidance power of six months, the Court allowed the recovery from the Centre according to Article 58 (1) of the General Principles of Civil Law, which states that a contract shall be void if it is used as a means for unlawful activity[6].

Another development in this regard is a new set of Bankruptcy Law Interpretation of the Supreme People’s Court in 2002 (“the 2002 Supreme People’s Court Interpretations”)[7], which introduces a new procedure to deal with potential wrong doing in practice. Article 12 of the new Interpretations provides that a bankruptcy petition by the debtor shall not be accepted if a People’s Court finds the debtor intends to evade his debt obligation with concealment and transfer of his assets. Article 14 mandates the court to dismiss the case after the petition has been accepted, if the court finds that the whereabouts of a large amount of the debtors’ assets are unknown and the debtor is unable to reasonably account for the disappearance. In these circumstances, the case may be transferred for criminal investigation. As a result, the period of the “twilight Zone” may not be certain at all.

As far as directors as individuals is concerned, the 2002 Supreme People’s Court Interpretations further expand directors’ liabilities. According to Articles 41 and 42 of the Bankruptcy Law, a legal representative, such as chairman of the board of directors or the general manager of a SOE, and other responsible persons shall be subject to administrative and criminal liabilities for fraudulent or unfair transfer of the bankrupt assets as stipulated in Article 35 of the Law. Article 101 of the Supreme People Court Interpretations provides that the liquidation committee may take legal action for damages and compensation against the legal representative or other responsible persons caused by their violation of Article 35 of the Law. Apparently, such lawsuits are not subject to any “twilight zone”, but the statutory limitation under the Civil Procedure Law (normally two years).

To sum up, the current legal regime does not clearly define the “twilight zone” because the recent government and judicial circular apparently break through the provision of the SOE Bankruptcy Law. It should be further noted that directors of different types of enterprises may be subject to not only civil, but also administrative and criminal liabilities in China, particularly when state assets are involved. According to the 2002 Draft Bankruptcy Law, the avoidance period will be stretched from six months to one year counting from

[6] The case was reported in the Second Economic Trial Division of the Jilin High People’s Court (compiled), *Applicable Laws and Documentation Format* (Jilin People’s Publishing House, 2000), at 51 (in Chinese).

[7] Provisions of the Supreme People’s Court on Certain Issues Concerning Trials of Bankruptcy Cases of July 30, 2002.

the date when the bankruptcy petition is accepted by the people's court (Article 23). However, Article 35 states that any concealment and unlawful distribution of debtor's property or assets, or fabrication of debts, shall be void, no matter taking place at what time. Article 36 empowers the bankruptcy administrator to recover such property and assets and Article 38 mandates recovery of abnormal income of directors from the debtor company or assets of the debtor taken by the directors. Both Articles 36 and 38 do not specify any time limits.

QUESTION 2

2. Actions potentially giving rise to liability for directors

As afore-discussed, the directors' liabilities vary in enterprises of different ownership. The current Company Law with five short articles articulating directors' duties and obligations is considered defective, not only for its over-simplicity,[8] but also for its failure to use the crucial word of "fiduciary" to describe the directors' duties.[9] Under the Company Law, directors and senior officers shall be liable for the damages to the company only if such damages are caused by their violation of the law, regulations or the company's article.[10] As such, the Law fails to provide sufficient, to say the least, legal ground to institute actions of wrongful negligence, abuse of majority's power and transactions under value. Chapter 10 of the Law entitled Legal Liabilities only imposes administrative and criminal liabilities against directors' misappropriate the company's assets[11] and engagement in conflicting business.[12] Article 57 of the Law further disqualifies directors for three years for their personal responsibility for bankruptcy of the company they have served.

The Criminal Law of 1997 has some articles against directors for their unlawful profiteering by taking advantages of their positions,[13] for making significant losses to the company by engaging in dealing with family members and friends,[14] for their negligence resulting in a significant loss to the company,[15] and for seeking their own benefit at the cost of the company.[16] However, all these criminal penalties may only be applicable to cases involving state-owned companies and enterprises. Consequently, the legal means with their effect of determent are not available to private companies and firms against directors' wrong doing. Articles 271 and 272 of the Law

8 See Articles 59-64 of the Company Law that are applicable to both limited liability companies and joint stock companies with limited liability.

9 Article 59 requires a director to follow the articles of the company, faithfully discharge his duties, to uphold the company's interests and not to seek any personal interest by taking advantage of his power and position in the company. However, some experienced lawyers believe the failure to impose fiduciary duty on directors is a sad mistake. See Nicholas C. Howson, "China's Company Law: One Step Forward, Two Steps Back? A Modest Complaint", *Columbia Journal of Asian Law*, No. 1 (1997), at 142-144.

10 Articles 63 and 118 of the Company Law.

11 Ibid., Article 214.

12 Ibid., Article 215.

13 Article 165 of the Criminal Law.

14 Ibid., Article 166.

15 Ibid., Article 167.

16 Ibid., Articles 168 and 169.

also provide causes of actions against directors of all kinds of companies, but only limited to misappropriation.

In recent years independent director as a means to improve corporate governance of Chinese enterprises, particularly listed companies has been introduced into China. As a result, a new cause of action against independent directors has soon emerged. In 2001 the China Securities Regulatory Commission ("CSRC") imposed fine against directors of Zhengzhou Baiwen Company after serious misrepresentation and insolvency were revealed. One of the independent directors lodged his appeal for reconsideration on the ground that his post was an honorary one and he did not participate in the company's management, nor received any honorarium. The CSRC rejected his arguments and later the People's Court dismissed his claim on the ground of statutory limitation. Although the court did not rule on substantive matter, it has been widely agreed that the case will have significant impact in the directors' duty and liabilities.[17]

The 2002 Supreme People's Court Interpretations attempt to streamline the practice. Under Article 100, the legal representative of a bankrupt enterprise and other responsible persons shall face administrative or criminal liabilities for their unfair or fraudulent transfer of assets. Needless to say, the administrative penalties may only be imposed on those state cadres responsible for managing SOEs and state assets. Article 101, as aforementioned, subjects management of the bankrupt to civil liabilities for their violation of Article 35 of the Bankruptcy Law.

Article 102 requires the People's Court to transfer the information and materials to the state authority for criminal investigation if it finds that whereabouts of a large amount of enterprise assets are unknown in bankruptcy proceedings.

These rules clearly demonstrate that directors may face all administrative, criminal and civil liabilities in bankruptcy proceedings. These penalties are also included in Chapter 9 (Legal Liabilities) of the 2002 Draft of the Bankruptcy Law of PRC. However, the lack of supervision and enforcement has rendered the law not as harsh as it sounds in practice. In companies and other enterprises actions against directors' dishonest trading and transactions would be more difficult simply because there is no detailed provisions on directors' fiduciary duty, nor any rule defining and governing insolvent trading, false representation to company creditors and fraud in anticipation of dissolution.

On the other hand, the unsophisticated legal regime does not allow some defences that are commonly available in other jurisdictions. For example, the imposition of liabilities seems to only focus on the losses or damages to the company without paying sufficient attention to the knowledge or mental state of the director concerned. Worse yet, the underdevelopment of professional services, such as accounting and auditing may make a director more vulnerable in arguing his case for his business Judgment.

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17 The case was reported and discussed in Feng Guo, Zhang Yan and Tao Guanghui (ed.), Cases in China Securities Market, People's University of China Press, 2003, at 93-116 (in Chinese).

QUESTION 3

3. Other persons may be liable during the "twilight period"

Given the corporate structure and business environment, some other persons may also be liable due to their involvement with the company's affairs during the "twilight zone". First, China's Company Law is based on the German model with a supervisory board parallel with the board of directors as an organ to monitoring directors' performance. As a result, a supervisor is treated virtually the same as a director in terms of legal liabilities. By the same token, the managers are also included into the same framework.[18] As such, if supervisors and managers fail to carry out their legal duties, the same liabilities will be imposed.

As a socialist market economy, the government involvement in the operation of many companies and SOEs are still substantial. Consequently, certain state officials may become liable for their wrong doing with the enterprise concerned. Article 42 of the SOE Bankruptcy stipulates that if the upper-level government department is found mainly responsible for the bankruptcy of the enterprise concerned, the leaders of the department shall be disciplined. Where their negligence causes significant losses to the state, they may even be subject to criminal penalties.

Also in many cases bankrupt companies were established by the local government directly without sufficient capital to meet the minimum capital requirement of the law. Although the doctrine of "lifting the corporate veil" is not provided in the Chinese law today, the People's Court in fact has repeatedly applied the rule in practice through judicial interpretation. For example, in *Pin Ding Branch of Shaxi Oil Co. v The Oil Development Group of Bai City of Jilin,* the Supreme People's Court held that the defendant company's veil should be pierced and the government office was liable to the extent of the registered capital on the finding that the company, without any of its own capital, was established by the local government and the company's assets were later transferred to another firm formed by the same government office before a judgment was issued in favour of the creditor plaintiff.[19]

In addition to the management and responsible officials, the promoters and shareholders of a company shall be liable for failure to make their capital contribution or withdrawal of their capital contribution after the formation of the company. Article 25 of the Company Law requires all the shareholders to make their capital contribution in full before the establishment of the company. As a result, a shareholder shall be liable for the unpaid part of his capital contribution. In a bankruptcy case in 1995, a mainland company and a Hong Kong company formed a joint venture in 1989 with a registered capital of

[18] In all the articles of the Company Law examined above, directors, supervisors and managers are named together. In China, excessive concentration of power has been a serious problem of corporate governance where in a large number of companies, the chairmen of the board are also the general managers.

[19] The case is reported in the Research Office of the Supreme People's Court, Collection of Judicial Interpretation of the Supreme People's Court, vol. 1 (1949-1993), (People's Court Publishing House, 1994), at 1570-72 (in Chinese).

US$ 1.1 million. By 1993 the capital of the joint venture was raised to US$2.4 million, but never fully paid. In 1995 the joint venture was in a bankruptcy proceeding, where the mainland company wanted to set off its claims against the joint venture with its unpaid capital. The Supreme People's Court instructed the High People's Court that in order to protect other creditors' lawful interests, the set-off request should be rejected.[20] Under Article 209 of the Company Law, a fine up to ten per cent of the fund withdrawn shall be imposed. In a serious case, criminal penalties may even be used.

Professionals who are involved in the company's affairs may be liable for their fraudulent conducts in practice, including the "twilight period". Article 219 of the Company Law stipulates that asset appraising and certifying firms may be fined, closed down and even subject to criminal liabilities for their issuing false documents. In case of negligent omission in appraising and certifying reports, fine, suspension of business and disqualification may be imposed.

The Commercial Bank Law prohibits a commercial bank from granting loans on a credit basis to its affiliate or granting other types of loans with preferential conditions.[21] Further, the People's Bank of China as the central bank adopted the General Principles of Loan Granting in 1996. Chapter 11 in particular specifies administrative, civil and criminal liabilities against violations of the banking law and loaning procedures. In addition to subjecting the borrower to criminal penalties who intentionally embezzles the proceeds in way of bankruptcy, the responsible bank staff and any individual or entity that coerces the bank to issue the loan will be disciplined.

Indeed, the current law does not have many rules on the liability of a third party, except those discussed above. However, the very general and broad provision of the General Principles of Civil Law may always be relied on by the court in handling a third party dealing with a company with knowledge of its insolvency or in conspiracy with the company or its directors. For instance, Article 106 provides that a natural or legal person shall bear civil liabilities for his violation of other's property rights at fault. Article 73 of the 2002 Supreme People's Court Interpretations stipulates that the liquidation committee shall issue notice to debtors of the bankrupt enterprise and anyone who takes possession of the bankrupt's assets and ask them to repay their debts or return the assets concerned to the committee within specified time. If they neither settle the debt or return the assets, nor dispute the claim of the liquidation committee with reasonable grounds, the People's Court may enforce the claim upon the committee's application.

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20 The Reply of the Supreme People's Court to The High People's Court of Hubei on the Issue Whether Bankruptcy Claims Can Be Set Off with Unpaid Capital dated April 10, 1995; printed at Li Guoguang, Xi Xiaoming and Cao Shibing, "Correct Understanding of the 2002 Supreme People's Court Interpretations", Legal System Publishing House of China, 2002, at 369 (in Chinese).

21 Article 40 of the Commercial Bank Law of 1995

QUESTION 4

4. Counterparties dealing with the company during the "twilight zone"

Generally, as discussed above transactions with the company within six months prior to the commencement of the bankruptcy may be vulnerable to the attack of avoidance power, and once a company is liquidated, it may not engage in any new operational activities.[22] However, what constitutes "new operational activities" is not defined in the law. In a reply in 2000, the Supreme People's Court held that the bankrupt enterprise shall stop its operation once the bankruptcy declaration is made. However, it may continue its business operation up to the end of the bankruptcy proceeding if such operation is approved by the liquidation committee and reported to the People's Court. Moreover, no contract will be valid in this period unless it is concluded by the liquidation committee and related to its function.

According to Article 18 of the 2002 Supreme People's Court Interpretations, in order to improve the bankruptcy case handling and fill up the administrative vacancy in the period between the case acceptance by the People's Court and the bankruptcy declaration is made resulting in the formation of the liquidation committee, an enterprise supervisory committee may be established. It will be responsible for verifying and liquidating assets and managing the business operation of the enterprise concerned in the practice.

Also under Article 24 of the SOE Bankruptcy Law, the liquidation group may conduct necessary civil activities in accordance with the law, including making decisions on whether to continue to perform contracts of the enterprise.[23] Thus, the counter-parties may still be able to deal with the company in the "twilight zone". However, the current regime includes no specific definition in this regard.

Moreover, the SOE Bankruptcy Law allows an insolvent SOE to carry out reconsolidation within two years if its upper-level authority and the creditors' meeting so agree. In the period of reconsolidation, the enterprise may continue its business operation subject to the supervision of the People's Court and the creditors' meeting as well as the state authority. However, the rescue process shall be terminated if the financial condition of the enterprise continues to deteriorate or the debtor commits unfair preference damaging the interest of creditors.[24] Based on these provisions, it seems likely that some counter-parties may continue to deal with the debtor enterprise subject to the permission of the liquidation committee, creditors' meeting and the relevant state authority. In this regard, the only defence for the counter-parties for validating a transaction with the debtor enterprise would be that such continued dealing benefits the enterprise concerned.

[22] Article 195 of Company Law

[23] Article 55 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Enterprise Bankruptcy Law of November 7, 1991

[24] See Chapter 4 of SOE Bankruptcy Law. Also, Chapter 5 of the Supreme People's Court's Opinions, Ibid.

QUESTION 5

5. Enforcement actions

According to Article 35 of the SOE Bankruptcy Law, the liquidation committee may petition to the People's Court to avoid the transaction of unfair preference or fraudulent transfer. The upper-level state department of the SOE concerned and the Ministry of Supervision is empowered to discipline the directors responsible for the unfair preference transactions or for losses of the SOE due to their negligence under Articles 41 and 42 of the Law. If the case proves to be very serious, they may further refer the case to the People's Procuratorate for criminal investigation. These organs may also handle the fraudulent bankruptcy cases according to the measures adopted by the State Council and the Supreme People's Court as discussed above.

For all the criminal liabilities as provided in the Company Law and the Criminal Law, it is no doubt that the People's Procuratorate shall bring the action against directors for their offences. However, in practice before the case reaches to that stage, many other state authorities may already get involved in deciding the nature of the case. For instance, the Disciplinary Committee of the Communist Party,[25] the State Asset Management Commission, the Ministry of Supervision, the State Auditing Administration, the State Administration of Industry and Commerce as the business registration authority and the relevant state department in charge of the SOE or company concerned may all participate in the investigation and put forward their opinions.

A company may have a cause of action against directors for breach of their legal duties and for violations of the law and regulations resulting in losses to the Company. The directors concerned shall compensate the company for the losses caused by their wrong-doing and further be accounted for the unlawful income they made by means of corruption, misappropriation, and conflict of interest dealing.[26]

Based on the relationship between the directors and shareholders, the latter should be able to institute legal actions against directors' wrong doing. However, the Company Law includes no specific provision to enable shareholders' derivative action. Indeed, certain ministerial regulations entitle both the company and its shareholders to file legal actions against the directors for their violation of the articles of the company.[27] However, these rules have very limited applicability, applicable only to overseas listed companies. Moreover, currently most of companies' articles are very simple and general, which may further hinder shareholders' actions. Further, lack of necessary substantive and procedural rules in this regard has troubled the People's Court in handling such cases. For example, in a widely reported

25 Article 17 of Company Law allows activities of the Communist Party in a company.

26 Ibid., Articles 59 - 63, 118 and 123.

27 For instance, Article 7 of the Requested Clauses for Articles of Association of Overseas Listed Companies jointly promulgated by the State Securities Commission and the State Economic Reform Commission on August 27, 1994 provides that the company or its shareholders may sue the directors based on the provisions of the articles association.

case, a derivative action filed by a foreign shareholder against the chairman of the company could not be entertained by the People's Court.[28]

There is no specific rule for a third party, such as a creditor, to sue directors for any wrong doing during the "twilight zone", the General Principles of Civil Law, such as Article 106 mentioned above, nonetheless, may always come to play a helpful role.

QUESTION 6

6. Remedies: orders available to the domestic court

As discussed above, the remedies for unfair preference and fraudulent trading during the period of the "twilight zone" can be grouped into three aspects: administrative, civil and penal.

Administrative liabilities: In a socialist market economy, administrative sanctions as a distinctive feature of the contemporary Chinese legal system are more commonly used than in other jurisdictions.[29] With respect to unfair preference or fraudulent trading, the legal representative and the directly responsible persons of the bankrupt enterprise shall be subject to administrative sanctions under Article 41 of the SOE Bankruptcy Law, which may include fine, rank reduction, and dismissal. Further, according to Article 100 of the 2002 Supreme People's Court Interpretation, when trying an enterprise bankruptcy case, the People's Court discovers that the bankrupt enterprise's original legal representative or directly responsible person has committed any of the acts enumerated in Article 35 of the SOE Bankruptcy Law, it shall refer the case to the relevant department with a view to imposing an administrative sanction upon the legal representative or directly responsible person. In a case where he is suspected to have committed a crime, the People's Court shall transfer the relevant materials to the relevant state organ for investigation.

Civil remedies mainly focus on (a) setting aside unfair preference or fraudulent transactions and recovery of the property concerned; and (b) holding responsible directors liable to the company.

During the "twilight zone", the liquidation committee, the company, the relevant state authorities, or the third party all has the right to certain extent to apply to the People's Court to avoid the transaction and recover the property concerned. The authorities in this regard include Article 35 of the SOE Bankruptcy Law; Articles 63, 118, 214 and 215 of the Company Law; Article 106 of the General Principles of Civil Law and relevant provisions adopted by the State Council and the Supreme People's Court as aforementioned.

[28] For a comment of this case in English, see Xian Chu Zhang, "Practical Demands to Update the Company Law", *Hong Kong Law Journal,* part 2 (1998), at 248-260.

[29] Article 1 of SOE Bankruptcy Law states that the law is formulated in order to promote the development of the planned socialist commodity economy

For example, Article 101 of the 2002 Supreme People's Court Interpretation provides that where the bankrupt enterprise has committed any of the acts enumerated in Article 35 of the SOE Bankruptcy Law, and thus causing the enterprise properties unable to be recovered, and causing actual losses, the liquidation committee may bring a civil lawsuit against the bankrupt enterprise's original legal representative or directly responsible person and hold him liable for the losses. Article 63 of the Company Law mandates a director to pay compensation to the company for losses caused in violation of the law, administrative regulations and article of association of the company during performance of their duties. Under Article 118 of the Company, directors shall be responsible for the severe loss of the company caused by any resolution in violation of the law, administrative regulations or the article of association, unless they can prove their objection to the adoption of the resolution, which should be recorded in the minute of the board meeting.

The current legal rules also empower the People's Court as a state organ to take action by itself to recover the relevant assets. Article 40 of the SOE Bankruptcy Law, for example, stipulates that the People's Court shall recover the assets if the unfair preference transaction is discovered within one year of the conclusion of the bankruptcy proceeding and make distribution among the creditors in accordance with the priority order as provided by the law.

Penal remedies imposed on the directors of SOEs or state companies include fine, criminal detention, and imprisonment up to seven years for their self-dealing, gross negligence or seeking personal gains at the cost of the state firms.[30] However, these articles may only apply to state owned entities. However, under Article 102 of the 2002 Supreme People's Court Interpretation, after acceptance of an enterprise bankruptcy case, if the People's Court discovers that the enterprise has a substantial amount of assets with their whereabouts unknown, it shall turn over the relevant information and materials on the suspected crime to the relevant state organ for investigation. It shall be noted that this provision applies to all enterprise legal person. In addition, Articles 271 and 272 of the Criminal Law stipulate that the staff of a company may be penalized with confiscation of personal assets, criminal detention or imprisonment up to ten years if he takes advantages of his position to misappropriate the assets of the company.

Apart from the penalties mentioned above, disqualification may also be used as a punishment. For instance, pursuant to Article 103 of the 2002 Supreme People's Court Interpretation, the People's Court may suggest to the relevant department that it restrict the responsible persons of the bankrupt enterprise from re-establishing an enterprise, or prohibit them from holding the posts of company directors, supervisors or managers within a statutory period. Article 57 of the Company Law stipulates that a person who served as a director of bankrupt enterprise or company and personally responsible for its insolvent liquidation due to poor management, shall not be appointed as a company director, supervisor and manager for three years of the date of the conclusion of the bankrupt proceedings.

[30] Articles 165-169 of the Criminal Law
[31] Article 8(2), SOE Bankruptcy Law

QUESTION 7

7. Duty to co-operate

The SOE Bankruptcy Law and 2002 Supreme Court Interpretation set out the rules governing the directors' duty to cooperate with the liquidation committee during the liquidation period.

First, when the debtor enterprise submits the bankruptcy application, it shall explain the conditions of its losses and deliver relevant accounting books, a detailed list of liabilities and accounts receivable to the People's Court.[31] The People's Court shall, after acceptance of the enterprise bankruptcy case filed by a creditor, notify the debtor to submit to the People's Court within 15 days the relevant accounting statements, the detailed list of claims and that of debts, the detailed list of enterprise assets, and other materials which the People's Court requires to be submitted.[32]

Second, Article 13 (3) of the Law mandates the legal representative of the debtor enterprise, namely the general director of the SOE or chairman of the board of the company, to attend the creditors' meetings and under the legal duty to answer the creditor's inquiries. If he refuses to attend, the People's Court may carry out a mandatory summon in accordance with the Civil Procedure Law.[33]

Third, the legal representative of the bankrupt enterprise shall be responsible for taking custody of the property, account books, documents, materials, seals, etc. of such an enterprise before they are handed over to the liquidation committee.[34] After deciding to accept an enterprise bankruptcy case, the People's Court shall within ten days, publicize an announcement in the debtor's enterprise, requiring the debtor to preserve the enterprise properties. The legal representative, the accountants and the property custodians of the bankrupt enterprise must stay behind for duty. At the same time, the debtor is forbidden to dispose of the enterprise's account books, documents, materials, seals, or conceal, secretly distribute, transfer or sell the enterprise properties without authorization. The debtor is also required to immediately cease repaying the debts, and not to pay any expenses without the permit of the People's Court.[35]

Fourth, before the conclusion of the bankruptcy proceedings, the legal representative of the bankrupt enterprise shall carry out the duties according to the requirements of the People's Court or the liquidation committee, and may not leave his position without authorization. The Supreme People's Court held that an offence may be committed if the legal representative leaves before the conclusion of the bankruptcy proceedings without authorization, or avoids his duties in any other ways, or refuses to carry out transfer procedure to the liquidation committee. The Court may impose fine, detention or other criminal penalties according to the severity of the conduct.[36]

[32] Article 16, the 2002 Supreme Court Interpretation.
[33] Article 32 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Enterprise Bankruptcy Law of November 7, 1991
[34] Article 27, SOE Bankruptcy Law
[35] Articles 15 and 37 of the 2002 Supreme People's Court Interpretation
[36] Supra note 33, Article 20.

Fifth, after the bankruptcy order is made, the former legal representative of the bankrupt enterprise shall continue to be under a legal duty to organize the accountants of the enterprise to finalize all the account, other relevant people to make the detailed property list, and business staff to clear their business. Upon completion, the legal representative shall transfer all these work to the liquidation committee.[37]

Finally, all the employees of the bankrupt enterprise may also under a legal duty to safeguard its assets during the liquidation. Once the bankruptcy case is accepted the People's Court shall make a public notice to all the employees, requiring them to protect the enterprise assets and to prevent the account books, documents, materials and seals from being unlawfully disposed and the assets from being concealed, partitioned, transferred without consideration or sold below value.[38] Further, after the bankruptcy order is made, the People's Court may ask the legal representative and certain other staff from financial, statistical, warehouse and security departments to stay behind to take care of unfinished matters. Once the order is so made, they have no choice, but to follow.[39]

In addition to the debtor enterprise and its staff, other persons or entities may also owe a duty to be cooperative during the liquidation process. Article 25 of the SOE Bankruptcy Law, for example, states that no unit or individual may illegally dispose of the property, account books, documents, materials, seals, etc. of a bankrupt enterprise. The debtors of a bankrupt enterprise and persons in possession of the property of the bankrupt enterprise shall repay their debts or deliver the property only to the liquidation committee. The debtor's bank of deposit is required, after the People's Court decides to accept a bankruptcy case, to cease the settlement for the debtor and limit the bank account to the use by the liquidation team. The bank shall not use the debtor's money for settling the debts, unless otherwise permitted by the people's court in accordance with the law.[40]

To some extent, the other People's Courts also have a duty to cooperate with the court hearing the bankruptcy case. According to Article 36 of the 2002 Supreme People's Court Interpretations, after bankruptcy declaration, in case where the bankrupt enterprise's properties are sealed up, distrained or frozen in other civil procedures, the People's Court that accepts the bankruptcy case shall immediately notify the people's court that takes the measure of sealing up, distraining or freezing the properties to cancel the measure, and transfer the case to the People's Court that accepts the bankruptcy case.

In the "twilight zone" the People's Court has a broad power to investigate into a dispute and to enforce duties to cooperate. Although the SOE Bankruptcy Law and the Company Law contain little specific provision in this regard, the rules of the Civil Procedure Law may always come to help. Under Chapter 10 of the Law, the People's Court may resort to compulsory measures to force relevant persons to appear before the Court, to participate in litigation and to assist the investigation.[41] Article 65 of the Law provides that the People's Court is empowered to investigate into, and obtain evidence from, any entity

37 Ibid, Article 54.
38 Ibid.
39 Ibid. Article 49.
40 Article 15, 34, 2002 Supreme People's Court Interpretation.
41 In particular, see Articles 100, 102 and 103 of the Law.

or individual, who shall not refuse. Article 70 imposes a legal duty on any entity or individual who has knowledge of the relevant fact to testify before the Court. The latest version of the Draft Enterprise Bankrupt and Reorganization Law of the PRC has more specific provisions in the respect of mandatory cooperation in liquidation period. However, in China the underdeveloped evidence regime includes few rules on cooperation defence, such as privileged communication.

With regard to the applicable human rights law in the “twilight zone” period, not much can be specifically found from the current regime. Generally, the Chinese laws do not definitely address the concept of self-incrimination when it concerns with the privilege. Criminal Procedure Law of China explicitly stipulates that no person shall be found guilty without being tried by the People’s Court,[42] but the Law mandates all the suspects to truthfully answer all the investigation questions which are relevant to the case.[43] An unsatisfactory aspect is that to some extent, the defendant’s right of accessing lawyers is restricted during some periods.[44]

Nevertheless, this does not mean that no human right law is available for criminal proceedings in China. As a whole, China has made a momentous progress in terms of protection of lawful rights of defendants which is incarnated in the Criminal Procedure Law and relevant laws and regulations. In addition to the relevant provisions in the Constitution Law,[45] to match with the aim to protect the citizens’ personal rights, their property rights, democratic rights and other rights,[46] the Criminal Procedure Law contains provisions that safeguard the fundamental rights. A director may rely on these articles to protect his lawful rights.[47]

With respect to the international convention relating to human rights, China became a signatory to the International Covenant on Civil and Political Rights in 1998. And some active preparatory measures have been taken to ratify this Covenant by the National People’s Congress since 2003. China is also a member of United Nations Treaty against Torture and some other conventions relating to the protection of human rights.

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42 Article 12 of the Criminal Procedure Law

43 Ibid., Article 93

44 Article 33 of the Criminal Procedure Law stipulates that the suspect may not appoint his lawyer until the Public Security Office has completed its investigation and has transferred the case to the People’s Procuratorate for prosecuting.

45 The Constitution of the People’s Republic of China was adopted at the fifth session of the fifth National People’s Congress on December 4, 1982, and amended in 1993, 1999 and 2004. Article 37 provides that freedom of the person of citizens of the People’s Republic of China is inviolable. No citizen may be arrested except with the approval or by decision of a people’s procuratorate or by decision of a people’s court, and arrests must be made by a public security organ. Unlawful detention or deprivation or restriction of citizens’ freedom of the person by other means is prohibited, and unlawful search of the person of citizens is prohibited. Article 38 further prohibits libel, false accusation or false incrimination directed against citizens by any means.

46 Article 2 of the Criminal Procedure Law

47 For example, a defendant shall have the right to defense, and the People’s Courts shall have the duty to guarantee his defense under Article 11. See also Articles 12, 14, 32, 43, 46,48, and 93 of the Criminal Procedure Law.

QUESTION 8

8. Appeals and limitation periods

Generally, according to Articles 135 and 137 of the General Principles of Civil Law the statutory limitation of civil actions shall be two years running from the time of infringement or the time the injured party knows or should know the infringement. This period in nature may be a variable period due to suspension[48] or interruption.[49] However, under Article 137 of the General Principles of Civil Law, the People's Court shall not entertain a civil action if 20 years have passed since the infringement. The 20-year-period is in nature invariable period, regardless of any suspension or interruption.

Bankruptcy laws and regulations also set out some limitations applicable to bankruptcy and liquidation proceedings. With respect to an unfair preference transaction by the bankruptcy enterprise discovered within one year of the conclusion of the bankruptcy proceedings, the People's Court shall recover the property and order repayment in accordance with Article 40 of the SOE Bankruptcy Law. The Draft Enterprise and Reorganization Law further extends this period to two years.[50]

Moreover, as aforementioned the State Council and the Supreme Court have adopted some rules to recover assets of fraudulent transactions and to punish responsible persons without specific time limitation.[51] Although these rules may be considered temporary measures against bankruptcy fraud in a transitional period from a planned economy to a market-oriented economy, they will have important impacts on many legal actions in the future.

Currently, there is no special limitation period applying to actions against directors and other officers in the SOE Bankruptcy Law and relevant legislation. As a result the normal limitation of civil and criminal actions shall be applied to these actions. At the same time, Chinese laws are silent in the time frame of the disqualification proceedings as well as its appeal procedures, although the Company Law stipulates disqualification mechanism against responsible directors and officers. As such, a set of detailed rules needs to be adopted to ensure the due process.

Where directors and other officers' acts constitute criminal offence, the limitation period prescribed in the Criminal Law of PRC shall apply. In accordance with Article 87 of the Criminal Law of PRC, crimes are not to be prosecuted where the following periods have elapsed:

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48 According to Article 139 of the General Principles of Civil Law, a limitation of action shall be suspended during the last six months of the limitation if the plaintiff cannot exercise his right of claim because of force majeure or other obstacles. The limitation shall resume on the day when the grounds for the suspension are eliminated.

49 Article 140 of the General Principles of Civil Law provides that a limitation of action shall be discontinued if suit is brought or if one party makes a claim for or agrees to fulfillment of obligations. A new limitation shall be counted from the time of the discontinuance.

50 Pursuant to Article 147 of the Draft Law, within two years after the close of insolvency case, creditors may request the people's court to carry out additional distribution according to the distribution scheme if there is recovered property from unfair preference. In spite of this, additional distribution shall not be conducted in case where the amount of the property is too little to be distributed

51 See supra notes 3 and 4.

(a) In cases where the maximum legally-prescribed punishment is fixed-term imprisonment of less than five years, where five years have elapsed;

(b) In cases where the maximum legally-prescribed punishment is fixed-term imprisonment of not less than five years and less than ten years, where ten years have elapsed;

(c) In cases where the maximum punishment prescribed by the law is life-imprisonment or death, where twenty years have elapsed.[52]

Thus, the legally-prescribed punishment periods should be firstly decided according to relevant articles in order to make the limitation periods applying to criminal actions against directors clear.

With respect to actions against directors, there is no specific provision governing their appeals. Thus, their appeals against the decision of the first instance court in civil and criminal proceedings shall be governed by the relevant procedure laws.

Under Article 147 of the Civil Procedure Law, if a party refuses to accept a judgment of first instance of a local People's Court, he shall have the right to file an appeal with the People's Court at the next higher level within 15 days after the date on which the written judgment is served. Where a party refuses to accept a written order of first instance of a local People's Court which normally is used to deal with procedural matters, he shall have the right to file an appeal with a People's Court at the next higher level within 10 days after the date on which the written order is served.

If the defendant in a criminal proceeding refuses to accept a judgment or order of first instance court, he shall have the right to appeal in writing or orally to the People's Court at the next higher level according to Article 180 of the Criminal Procedure Law. The time limit as set out in Article 183 of the Law for an appeal or a protest against a judgment shall be ten days and the time limit for an appeal or a protest against a procedural order shall be five days. The time limit shall be counted from the day after the written judgment or order is received.

An administrative proceeding may also be commenced by an enterprise against a government authority for unlawful interference with its business autonomy. The party concerned may first require the state department to reconsider its decision under the Administrative Reconsideration Law of 1999. Article 5 entitles the party to file an administrative action based on Administrative Procedure Law of 1989. According to Article 38 of Administrative Procedure Law, if a citizen, a legal person or any other organization applies to an administrative organ for reconsideration, the organ shall make a decision within two months from the day of the receipt of the application, except as otherwise provided for by law or regulations. Anyone who refuses to accept the reconsideration decision may bring a suit before a People's Court within 15 days from the day of the receipt of the reconsideration decision. If the administrative organ conducting the

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[52] The period for prosecution is counted as commencing on the date of the crime. If the criminal act is of a continuous or continuing nature, it is counted as commencing on the date the criminal act is completed. See Article 89 of the Criminal Law.

reconsideration fails to make a decision on the expiration of the time limit, the applicant may bring a suit before a People's Court within 15 days after the time limit for reconsideration expires, except as otherwise provided for by law. The party may further appeal his case to the next higher level of the People's Court within 15 days after being served with the judgment of the first instance court.[53]

QUESTION 9

9. Foreign Corporations

"Foreign Corporation" is defined in Article 199 of the Company Law as "a corporation that is established according to foreign laws in a foreign jurisdiction". There are no laws or regulations specifically applicable to the bankruptcy liquidation of foreign corporations in China at present.

The Company Law fails to address any cross-border insolvency issue, but only briefly deals with winding up of branch of foreign companies. Article 203 provides that a branch of a foreign company shall not have a legal person status and the foreign company must be responsible for all the liabilities the branch incurred in China. Article 205 in particular states that liquidation in accordance with the law must be conducted when the foreign branch is withdrawn from China. The assets of the branch shall not be moved outside China before the completion of the liquidation.

Moreover, although there is no specific provision on whether transactions in the "twilight zone" applicable to foreign corporations, the rules of directors' duties and responsibilities shall be generally applicable to the business operation of foreign companies in China. Further, Article 204 of the Company Law stipulates that a branch of foreign company shall abide by the laws and regulations of China and shall not harm the social public interests of the nation. It can be inferred from this article that directors of foreign companies may be held liable if they commit unfair preference or fraudulent trading causing damages to the creditors or the interests of China.

As far as foreign investment enterprises in China are concerned, the law treats them as Chinese legal entities since they are registered in China under Chinese law. Nonetheless, the sensitivity of foreign investment does see some special regulations. For example, the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC"; now renamed the Ministry of Commerce) promulgated the Liquidation Measures of Foreign Investment Enterprises on July 9, 1996, which is only applicable to foreign joint ventures and wholly foreign owned enterprises in China. According to Article 2, however, the Measures shall not govern insolvency liquidation. Despite its limited

[53] Article 58 of the Administrative Procedure Law of 1989

application, Article 28 copies the provision of the SOE bankruptcy Law concerning unfair preference. Article 46 further holds the investor liable for unfair preference by way of restitution and compensation.

The Civil Procedure Law, Chapter 19 governs the debt repayment and bankruptcy procedures of enterprise legal persons other than SOEs and companies. However, the entire chapter includes only 8 short articles and the Supreme People's Court had to instruct the lower courts to make reference to the provisions of the SOE Bankruptcy Law when necessary.[54] It shall be noted that the 2002 Supreme Court Interpretations apply to the bankruptcy of foreign investment enterprise (FIE) provided that FIE is a legal person. This greatly improves the hearing of FIE bankruptcy case as the previous provisions of the Civil Procedure Law applicable to the bankruptcy of FIE are too simple to function in practice.

QUESTION 10

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10. Insurance

Although China traditionally heeds much more attention to the property and life insurance, there has recently been a fast improvement on the professional liability insurance in China. After the professional liability insurance for lawyers and accountants was marketed as a new device to control business risks, Ping An Insurance Company launched the first insurance plan for company's directors and high officers in Chinese market in January 2002. Nevertheless, it seems that director and officer's liability insurance has not gained enough attention. Presently, only several listed companies have bought this insurance for their directors and high officers. No directors or officers have bought liability insurance for themselves thus far.

The unpopularity of liability insurance in China mainly relates to the current legal and business environment. The current company law seems to establish directors' liability more on a collective, rather than individual, basis. Also, the underdeveloped corporate governance and excessive government involvement may sound too risky for insurance firms to get into the area. In addition, the inadequacy of relevant insurance legislation gives rise to the difficulties in quantum of compensation concerning liability insurance.

In recent years, there are more and more independent directors (or outside directors) in listed companies required by the Chinese Securities Regulation Commission (CSRC), the watchdog of securities industry in China. Vast risk and limited remuneration makes it very necessary to have professional liability insurance for these independent directors to fulfil their duties to protect the minority shareholder's interests. Therefore, several listed companies became the buyers of professional liability insurance although most of companies still regard it unnecessary.

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[54] Article 253 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Civil Procedure Law of July 14, 1992

This landscape will be changing, particularly with the enhanced competition in Chinese insurance market as a result of her WTO accession. More and more foreign investment insurance companies will introduce ripe and suitable products of professional liability insurance for directors and officers in China. And the improved corporate governance and decreased state ownership will also make this notion popular in the foreseeable future.

QUESTION 11

11. Incurring further credit and counter-party risks in dealing with a company during the "twilight period"

The SOE Bankruptcy Law and other legislations do not prohibit an enterprise from incurring further debts after entering into the "twilight zone" so long as they are not unfair preference or fraudulent transactions as prescribed in Article 35 of the Law or permitted by the relevant state authority, liquidation committee or the People's Court if the debts are incurred after the commencement of the bankruptcy proceeding. In practice, many enterprises in financial distress rely on the projection of new funds to avoid bankruptcy. According to the SOE Bankruptcy Law and the Civil Procedure Law, insolvency of a debtor is primarily determined on a cash-flow basis.[55] As a result, in cases where the debtor is able to raise further fund by selling its assets or receiving emergency loan during the twilight period so as to avoid its being declared bankrupt in a short time, the transactions may not go against the spirit of the Laws. The Supreme People's Court in its judicial interpretation also allows the liquidation committee to continue to honour any contract it wishes.[56] Based on the rules examined previously, the tests apparently focus on the fairness of the transaction terms and the authorization procedure.

In deciding the liability, the knowledge of a director concerned may also be relevant. It thus is necessary for a director to be continuously informed of the operational and financial conditions of the company so that he could make an informed decision on whether or not to incur certain debts, especially when these debts are likely to be scrutinized in the "twilight zone". This is because the commencing date of the twilight light zone is not certain until the People's Court accepts the case.

Transactions with the enterprise other than unfair preference prescribed in Article 35 of the SOE Bankruptcy Law during the "twilight period" should be valid. The tests of fairness of the transaction and the necessary authorization

[55] Article 3 of the SOE Bankruptcy Law provides that enterprises that, owing to poor operations and management that result in serious losses, are unable to repay debts that are due shall be declared bankrupt. According to Article 199 of the Civil Procedure Law, if an enterprise as legal person is in serious losses and unable to repay the debts that are due, the creditors may apply to a people's court for declaring the debtor's bankruptcy repayment, the debtor may also file at a People's Court to declare bankruptcy repayment. Although the bankruptcy reasons contained in these provisions are arguable and subject to criticism in China, they adopt in general a cash-flow test.

[56] Article 55 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Enterprise Bankruptcy Law of November 7, 1991

procedure shall be equally considered by a third party while dealing with a company in the “twilight zone” period. Further, the recovery from these transactions by a third party will be negatively affected if he knows or should have known about this company’s risky financial conditions.[57]

In terms of the validity of contract entered into by the enterprise that is declared bankrupt and permitted to operate by the People’s Court before the termination of bankruptcy procedure, the Supreme Court in a reply stated that after being declared bankrupt by the People’s Court, the enterprise shall cease operation on the day of bankruptcy declaration. If permitted by the liquidation committee, the bankrupt enterprise may be engaged in business related to the liquidation work and in the name of the liquidation committee. The liquidation committee shall report to the People’s Court. If the contract entered into by the bankrupt enterprise is not in the name of liquidation team or is not related to the liquidation, it shall be invalid.

Under the 2002 Supreme People Court’s Interpretation, an enterprise supervision group may be appointed by the People’s Court to verify and liquidate assets of the enterprise in the bankruptcy proceeding and engage in operational activities for the interest of the enterprise under the court’s direction. This new mechanism is introduced to fill up the gap on enterprise supervision in the period between the acceptance of the bankruptcy petition and the bankruptcy declaration where warrants to formally establish the liquidation committee, which may last a few months.

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[57] There is no direct provision in this regard in the SOE Bankruptcy Law and the Company Law. But Article 130 of the 2002 Draft Bankruptcy and Reorganization Law provides that a set-off shall not apply if an obligor to the bankrupt obtains an obligatory claim against the bankrupt with the knowledge of the bankrupt’s cession of payment or application for bankruptcy. This means that the obligatory claim shall not be set-off and accordingly, the counter-party could only participate in the bankruptcy proceeding for the distribution.

[58] The reply of the People’s Supreme Court on the Effect of Contract Entered into by the Enterprise That is Declared Bankrupt And Permitted to Operate by the People’s Court Before the Termination of Bankruptcy Procedure, No. 43 (2000) Judicial Interpretation of the People’s Supreme Court, adopted by the Judicial Committee in the 1138th conference, effective as of December 9, 2000.

[59] Article 18 of the 2002 Supreme People’s Court Interpretations.

EGYPT

Introduction

Under the Egyptian legal system, there is no comprehensive legal framework regarding the duties and liabilities of directors of commercial companies. Basically such duties and liabilities are left to be decided by the mutual agreement of the partners or the owners of the company, provided that such agreement should be compatible with general mandatory rules of law. Nevertheless in the absence of an agreement, such duties and liabilities shall be subject to the Egyptian Civil Code (Articles 516-520). It should also be noted that these duties and liabilities vary according to the different type of commercial company in question. Under Egyptian law six types of commercial companies exist: -

1. General Partnership.
2. Limited Partnership.
3. Particular Partnership.
4. Partnership limited by shares.
5. Limited liability company.
6. Joint stock company.

According to Egyptian Law there is a distinction between the terms “Insolvency” and “Bankruptcy”. The term “Insolvency” refers to the civil person's inability to pay his debts while the term “Bankruptcy” refers to legal or physical persons of a commercial character when they stop paying their commercial debts. Civil persons are subjected to less stringent rules than the rules of bankruptcy applicable to “merchants”. There is also a tradition of distinguishing between “commerce” and “trade”. Trade has the meaning of trading in goods and commodities; whilst commerce means trade and other assisting services such as transport. The 1999 act referred to throughout this article regulates all of these. Egyptian legal practitioners distinguish “Egyptian commercial act”, from “Egyptian trade law” and this chapter refers to the wider definition of commerce.

The following persons are considered “merchants” according to article (10) of the Code of commerce.

1. All persons professionally exercising in their name and on their account a commercial activity; and

2. All types of companies whatever its purpose is

Under Egyptian law, only general joint partners are considered merchants since they are personally liable for the company's debts with all their fortunes. Other 'partners' are not considered as Merchants since they are only liable for the company's debts in proportion to their shares. This chapter is confined to the rules of bankruptcy of merchants.

A draft of a “Unified Law of Companies”, may soon be issued which integrates all the different types of companies whether civil, commercial or investment companies, and will recognize the “One man company” as a type of the commercial company.

Following the Constitutional Amendment of 1980, Shariaa became the main source of Egyptian Legislation. However, due to the liberal interpretations of Shariaa Rules and Principles which were adopted by the legislative committees, flexible rules of law have developed. Modern legislation makes a compromise with the traditional views of Shariaa Jurists: it is compatible with Shariaa spirit and concepts and at the same time accepts developments in commerce and society in fields such as banking, insurance companies and joint ventures in application of the principle of "*Ijtihad*" unanimously recognized by all Islamic schools. While the charging of interest was regarded by traditional Shariaa jurists as forbidden usury, moderate jurists allow interest. Egyptian legislation permits interest to be accorded by courts in both civil transactions (4%) as well as commercial transactions (5%) and may also provide for interest as determined according to the rate set up by the Central Bank in certain cases. Egyptian courts apply and adjudicate claims for interest according to the rules provided by the law. Pursuant to Article (227) of the Egyptian Civil Code, the parties may agree upon another rate of interest provided that it does not exceed 7%. However, under Article (233) of the same Code "the legal rate of commercial interest on current accounts varies according to the local market rate applicable, and capitalization is effected according to commercial usage". Moreover, pursuant to Article (50) of the New Commercial Code, amounts paid by a merchant for the sake of one of his clients enjoy a higher rate of interest which is the rate of discount of the Central Bank of Egypt.

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 The Twilight Period starts from the date when a company stops paying its debts, and lasts until a final adjudication of bankruptcy is issued by the competent court, which has discretionary power to determine the date on which payment of debts was stopped. Consequently, although the start of the Twilight Period does not depend on the commencement of a formal insolvency procedure its duration does.

Thus, a merchant shall be considered in a state of bankruptcy if he stops paying his commercial debts following disturbance of his financial affairs. However, discontinuance of payment shall produce no resultant effect before a court ruling declares him bankrupt. (Article 550 of Law no 17 of Code of commerce no.17/1999)

1.2 Moreover, A trader may be declared bankrupt after his death or retirement if he died or retired from trade while in a state of discontinued payments. The request for a declaration of bankruptcy must be submitted during the year following the death or retirement from trade business. This period shall not begin to apply, in the case of retirement, except from the date of deleting the name of the trader from the Commercial Register. (Article 551).

1.3 The court shall determine in the bankruptcy declaration ruling a temporary date for discontinuing the payments. (Article 561). It is accepted that the start and duration of the Twilight Period depends on the nature of the transaction.

If in the bankruptcy declaration ruling the date on which the debtor discontinued paying is not defined, the date on which the bankruptcy declaration ruling is issued shall be considered a temporary date of discontinuing the payments.

However, if the bankruptcy declaration ruling is pronounced after the death of the debtor or after his retirement from trade business, without defining the date of discontinuing the payment, the date of his death or retirement from trade business shall be considered a temporary date of discontinuing payments, until further determination by the court.

It should be noted that in defining the date of discontinuing the payment, the court shall make use of each deed, statement of act issued from the debtor and revealing a disturbance of his works or his attempts to continue his trade activity by illegal means or harmful methods to his creditors. This will include an attempt by the debtor to escape or commit suicide, hide his property or sell property or goods at a loss, conclude loans with oppressive terms or enter into irrational speculations (Article 562).

The court may, on its own motion, or upon the request of the Public Prosecution, the debtor, one of his creditors, the trustee of the bankruptcy or other interested parties, modify the temporary date of discontinuing the payment to the date of ten days after the date of depositing a list of the funded debts with the clerks office of the court, and after the lapse of this period the date defined for discontinuing the payment shall become final.

The date of discontinuing the payment shall not be moved back to more than two years prior to the date of issuing the bankruptcy declaration ruling (Article 563).

The merchant shall not be declared bankrupt because of discontinuing the payment of the criminal fines, taxes, duties, or social insurance dues (Article 555)

1.4 The law provides that the issue of the bankruptcy declaration ruling shall fetter the hands of the bankrupt from managing and disposing of the property. The dispositions made by the bankrupt on the day the bankruptcy declaration ruling is issued shall be considered as made after the issuing of the ruling.

Accordingly, after the bankruptcy declaration is pronounced, the bankrupt shall not settle his debts, nor receive his due rights. However, if the bankrupt holds a commercial paper, its value may be settled to him at its due date, unless the bankruptcy trustee objects to such settlement (Article 590).

Fettering the bankrupt's hand from managing and disposing of his assets does not prevent him from taking steps to maintain and preserve his rights. (Article 589)

After the bankruptcy declaration ruling is pronounced, no set off shall take place between the bankrupt's due rights and his obligations unless a link connects them together. This linkage exists if the rights and obligations arise from one reason, or a current account comprises them (Article 591).

Another related provision is contained in Law No. 93/2000 regarding the Central Depository system of securities. The provision stipulates that where there are transactions in the stock exchange (in Egypt or abroad) on the day of declaration of bankruptcy by the court against a party to such transactions, all such transactions effected on this day shall be enforceable even if the settlement is after the judgment of bankruptcy (Law No 93 of 2000 Article 52).

1.5 The restrictions in 1.4 cover all property owned by the bankrupt on the day the bankruptcy declaration is pronounced and property which devolves on him while he is in bankruptcy, but it does not include:

(a) The property on which no attachment is legally permissible, and the allowance determined for the bankrupt as well as his family.

(b) Property which is not owned by the bankrupt.

(c) Rights connected with the person of the bankrupt or his personal status.

(d) Compensations payable to the beneficiary in a valid insurance policy concluded by the bankrupt before the issue of the bankruptcy declaration ruling. However, the beneficiary shall refund to the bankruptcy estate all insurance premiums the bankrupt paid from the date the court determines the date of discontinuing the payment, unless otherwise prescribed in the law. (Article 592)

1.6 The following disposals of a debtor's property may not be enforceable vis-à-vis the creditors if such disposals are made after the date of discontinuing the payment and before issuance of the bankruptcy declaration:

(a) Granting donations in whatever form with the exception of small presents offered according to usage and practice.

(b) Settling debts before their maturity date, whatever may be the method of settlement. Establishing a consideration amount for settlement of a commercial paper not prior to its maturity shall be treated as formal settlement before the maturity date.

(c) Settling due debts with other than the object agreed upon. Payment by means of commercial paper or bank transfer shall be treated as settlement with money.

(d) All pawn, other consensual deposit and all liens to be determined on the debtor's property as a guarantee for a debt prior to the deposit (Article 598)

1.7 If the other party to the transaction is connected or associated with the bankrupt company, this may cast doubts on the transaction and the court may accordingly consider any disposal related to him as not binding. However, if any of the acts that is considered as a crime according to the Penal Code and the rules of the bankruptcy as noted below and if the crime is connected with an agreement concluded by the debtor or any person with one of the creditors to grant this creditor special benefits (particular lien) in return for voting in favour of composition, the criminal court may, *motu proprio*, pass a judgment decreeing the nullification of this agreement and compelling the creditor to refund whatever he laid hold of by virtue of that agreement, even though the court might acquit him. The court, upon the request of the concerned parties, may also pass a judgment decreeing the payment of compensation if necessary. (Article 772)

QUESTION 2

2. Actions Potentially Giving Rise to Liability of Directors:

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above :

(i) Is any resulting liability against a director civil, criminal or both? ;

(ii) Can a director be made personally liable in respect of the whole loss caused to the company or to the deficit to creditors? ;

(iii) Will liability attach to individual directors in proportion to their specific involvement? ;

(iv) Is there a specified period before commencement of a subsequent insolvency liability to attach to a director? ; and

(v) What defences, if any, will be available in relation to each offence?

2.1 Once the adjudication is issued, the director shall be restrained from managing and disposing of the company's assets, except for the procedures or acts necessary for maintaining and preserving the company's rights as mentioned above.

Following the adjudication of insolvency, the court shall appoint a bankruptcy trustee (receiver) who becomes responsible for the management and maintenance of the estate of the bankruptcy and representing the creditors and the company in all actions and works necessary (Code of Commerce Article 573)

2.2 Acts, which may potentially give rise to liability of directors, can be classified into the following categories:

(a) Acts which may give rise to criminal liability of the directors

In order for directors to incur criminal liability, they must commit one of the bankruptcy crimes. Under the Egyptian Penal Code, bankruptcy may amount to a number of Criminal Offences, regulated under Articles (328-335 of the 1937 Penal Code no. 58 of 1937). Generally speaking these Offences may be classified into:

(i) Crimes of fraudulent insolvency: punished by 3 to 5 years of imprisonment. The following acts are examples for crimes of fraudulent insolvency with each considered a felony:

1. Falsification of the company's' books,
2. Embezzlement of or hiding part of the company's money or assets.
3. Fraudulent Transactions.

(i) Crimes of negligent insolvency: Crimes of negligent insolvency are punished by 2 years imprisonment, and constitute a misdemeanour.

Wrongful trading, preference, and negligently holding the company's books are considered examples of negligent insolvency

(b) Acts which may give rise to personal liability of directors

Directors are personally liable under Egyptian Commercial Code in all of their fortunes due to financial losses suffered by the company or partnership if they are joint partners in the company.

Thus, if the company is declared bankrupt, all its joint partners including director partners shall be declared bankrupt. This shall comprise declaring the bankruptcy of the joint partner who resigned after the company discontinued its payments, if the request to declare the bankruptcy of the company is submitted within one year from the date the partner is registered in the commercial register as having resigned from the company (Commercial Code Article 703)

If a bankruptcy petition is submitted for the company, the court may also pass a judgment in bankruptcy for all persons who under cover of this company carry out commercial operations for their own account, and dispose of the company's funds and property as if they were their own (Article 704/1).

However, if it transpires that the company's assets are inadequate to settle at least 20% of its debts, the court, upon the request of the bankruptcy judge, may decree that all or some of the board members or directors, jointly among themselves or severally, shall pay all or part of the company's liabilities, unless they establish that they exerted in running the company's affairs, the same care as that of a keen and careful person (Article 704/2)

Moreover, the court, *motu proprio* or upon the demand of the bankruptcy judge, may pass a ruling decreeing the forfeiture of some of the rights to vote or be elected, of the company's board members or of directors who have committed serious errors leading to confusion of the company's works and discontinuation of its payments. (Article 704 /3)

(c) Acts which may give rise to civil liability to directors

Under this classification, any act that has caused a material or moral loss to the company or to any other person and was due to the wrongful conduct of the director, shall make him liable. In such a case the director's liability will be subject to general rules of Tortious Liability in the civil law, article (163 to 174). Joint liability shall result in this connection.

2.3 Evidence

Evidence related to crimes require that bad faith (*mens rea*) should be proved. Such evidence is subject to the discretionary power that the judge enjoys regarding evidence evaluation.

Evidence related to negligent insolvency are subject to the basic criterion of "The reasonable man" and principles of tortious liability under civil law (art. 163).

Thus, Evidence may be accepted or refused according to the discretionary power of the judge in the light of the above mentioned rules and criteria.

QUESTION 3

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3. Other Persons involved with the Company's Affairs that May become Liable in Respect of their Actions during the Twilight Period.

3.1 As noted above partners, co-partners, shadow directors, de facto directors and former directors may become liable according to Article (703) of the Commercial Code which provides that if the company is declared bankrupt, all joint partners thereof shall be declared bankrupt. This shall comprise declaring the bankruptcy of any joint partners who resigned after the company discontinued its payments, if the request to declare the bankruptcy of the company is submitted within one year from the date the partner is registered in the commercial register as having resigned from the company.

The court shall pass a ruling in which it pronounces the company's declared bankruptcy together with the declaration of the bankruptcy of the joint partners, even though it may not have jurisdiction to declare the bankruptcy of these partners.

The court shall appoint for the bankruptcy of the company and the bankruptcies of the joint partners one judge and one trustee or more. However, each bankruptcy shall be independent from the others in terms of its assets and liabilities, as well as its management, the funding of its debts, and its termination. If a bankruptcy estate pays any sums due from another bankruptcy-estate, the paying estate has no right of recourse against the other estate (Article 612/2).

3.2 As for banks, third parties with knowledge of bankruptcy of the company and a person knowingly dealing with a director abusing his/her powers, it is important to note that their disposals may not be invoked vis-à-vis the group of creditors. Following are the types of disposals that shall not be insisted upon vis-à-vis the group of creditors:

(a) Granting donations, whatever their kind is, with the exception of small presents offered according to usage and practice.

(b) Settling the debts before their maturity date, whatever the method of settlement. Establishing a provisional amount for settlement of a commercial paper not yet maturing shall be considered as good as settlement before the maturity date.

(c) Settling the due debts with other than the object agreed upon. Payment by means of the commercial paper, or bank transfer shall be considered as good as settlement with money.

(d) All pawn or other consensual deposit, as well as all lien to be determined on the debtor's property as a guarantee for a debt prior to the deposit. (Article 598)

However, a court ruling may be issued for non-execution of all disposals by the bankrupt, other than those mentioned above, during the period referred to therein, vis-à-vis the group of creditors, if the disposal is harmful to it and the party disposed to was at the time of that disposal, aware of the bankrupt's discontinuance of payment. (Article 599)

QUESTION 4

4. Counterparties dealing with the company during the twilight period

Counterparties dealing with the company during the twilight period are two groups:

(1) Some of them are seeking to set aside certain acts made by third parties with the company, either by fraudulent means, or through piercing the principle of equality among creditors. The outcome of such procedure is to recover proceeds to the bankruptcy estate, or at least to render such acts as non-opposable against the creditors mass or group.

(2) Some others are seeking the contrary, i.e., they are the dealers with the company and wish to save their transactions therewith from being set aside.

The capacity "*d`ester en justice*" in this regard is not recognized to any of the creditors, but it is recognized solely to the "receiver" in his capacity as legal representative of both the creditors and the bankrupt (Commercial Code article 603). The "receiver" may also use, in addition to the provisions of the Commercial Law, the "*action paulienne*" contained in the Civil Code articles 237-243.

The judgment rendered (as to the non opposability) in favour of the mass of creditors, shall ensue that the counterparty will repay to the bankruptcy-estate what he obtained from the bankrupt by virtue of such transactions or restitute the value of the thing disposed of at the time of its receipt (article 602/1).

On the other hand, the counterparty shall have the right to recover the consideration submitted by him, if such consideration is found *per se* in the bankruptcy estate; and if not, the counterparty shall be entitled to request the mass of creditors to convey to him the "benefit" it drew from the unopposability of such disposition, and shall be entitled (for the rest of the consideration exceeding such "benefit") to participate in the bankruptcy-estate as an ordinary creditor ("*crediteur chirographaire*").

Another provision, inspired by the Islamic Shariaa, says that: "*where a counterparty sold a commodity, and did not receive anything of its value, he shall be entitled to recover such commodity if it is found per se in the bankruptcy estate*".

QUESTION 5

5. Enforcement: By whom may actions be brought against directors?

5.1 In the light of above, actions may be brought by:

(a) the court as noted above.

(b) the trustees, or the controllers.

(c) creditors or persons having legal interests within the limits prescribed by law.

(d) the prosecutor (District Attorney)

QUESTION 6

6. Remedies: orders available to the domestic court

See response to question 2.

QUESTION 7

7. Duty to co-operate: To what extent are directors obligated to co-operate with the investigation into the company's affairs following its insolvency?

Once the bankruptcy decision is issued, the bankrupt or the director is to co-operate with the investigation into the company's affairs especially in the following:

(a) The director should not hide any documents, papers or clarifications that may lead to fraudulent insolvency which may result in imprisonment of between 3 to 5 years. (Article 328 of the Penal Code)

(b) On the other hand, the company's directors are under a duty to submit its commercial books upon the court order, and the court has the discretionary power to sentence a director with a daily default fine.

(c) The director should attend when called the session of closing the commercial books (Commercial Code Article 640)

According to the Constitution, and the law of evidence a person may not be forced to incriminate himself. However, this is not the case if the bankrupt or the director hides books, documents or information that led to fraudulent bankruptcy.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any will apply to actions brought against directors (and others) in connection with the offences identified in question (2)?

(b) Is an appeal available from the decision of the lower courts?

8.1 Limitation periods

Limitation periods for penal proceedings

According to the Egyptian procedural penal code, the limitation period for the offence of fraud bankruptcy, which constitutes a felony, is ten years. Thus, when the period of ten years expires without bringing the action it may not be brought before the court .On the other hand, the limitation period for bringing an action in the misdemeanour of the bankruptcy by negligence is three years. If, however, the action was brought, and a condemnation sentence was rendered, the limitation periods for the felony and the misdemeanour become 20 years and 5 years respectively.

Limitation period for proceedings in which compensation is to be sought

Generally speaking, a compensation claim may rest upon principles of tortious liability or principles of contractual liability.

If the compensation claim is based upon tortious liability principles then the limitation period shall be either three years as of the date the claimant for damages knew of the loss and of the person liable for it or, in all cases, fifteen years from the date the loss or damage occurred. On the other hand, limitation periods for compensation claims based upon principles of contractual liability, are fifteen years.

However, court actions arising from the application concerning some disposals, shall prescribe after the lapse of two years from the date of issuing the bankrupt declaration ruling. Examples of this include:

(a) Making donations, of whatever kind, with the exception of small presents offered according to usage and practice.

(b) Disposals or settling debts before their maturity date, whatever the method of settlement. Establishing a provisional amount for settlement of a commercial paper prior to maturity shall be considered as settlement before the maturity date.

(c) Disposals of settling the due debts with other than the object agreed upon. Payment by means of the commercial paper, or bank transfer shall be considered as settlement with money.

(d) Disposals of pawn or other consensual deposit, as well as all liens to be determined on the debtor's property as a guarantee for a debt prior to the deposit. (Article 604 of the Commercial Code)

8.2 Appeals against decisions of the first instance court

Each interested party, other than the litigants, may object to the bankruptcy declaration ruling in the court issuing it within thirty days from the date of publication in the papers, unless it was appealed against in which case the objection shall be raised to the court examining the appeal.

The period for objection to all rulings issued in court actions as a result of the bankruptcy shall be thirty days from the date of their issuance, unless they are due for publication in which case the period shall begin from the date of publication.

The provisions of the Civil and Commercial Procedure Law shall apply to the rulings issued in bankruptcy declaration actions and other rulings issued in court actions resulting from the bankruptcy and the method of lodging them. (Article 565 of the Commercial Code) The period for appeals in these cases is 40 days.

It should also be mentioned that the rulings issued in bankruptcy actions shall be due for self- execution without bail, unless otherwise prescribed. (Article 566 of the Commercial Code)

However, no contestation shall be instituted in any way against:

(a) The rulings or decisions concerning the appointment or replacement of the bankruptcy judge, trustee, or controller.

(b) Rulings as issued in the objection against the decisions of the bankruptcy judge.

(c) Orders issued cancelling the custody proceedings on the person of the insolvent.

(d) Rulings issued for staying the bankruptcy proceedings until the final decision is taken in the objection lodged against the bankruptcy judge concerning acceptance or refusal of the debts.

(e) Rulings issued concerning acceptance of the litigious debts temporarily.

Appeals against penal proceedings

Appeals against penal proceedings in the case of misdemeanours should be filed within 10 days from the date of issuance or notification of the first instance court decision. Sentences handed down in felony cases are subject to no appeal, but may be submitted to the Court of Cassasion to examine the application of the law within 40 days from the date of issuance or notification.

QUESTION 9

9. Foreign Corporations

Legal provisions and procedures applicable to foreign corporations.

Under Egyptian Law, a foreign company and a branch agency in Egypt are subject to the same rules as domestic companies. Unless bilateral or a multi-lateral international-convention enforced in Egypt provides otherwise.

QUESTION 10

10. Insurance

Directors and officers of commercial companies may be insured according to the Egyptian Law and the rules of insurance companies.

However, it is very rare that this happens in practice, except in banks to the directors and some employees of banks, especially those having fiduciary duties towards their employer or institution.

ENGLAND

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 As a general rule, English law focuses on two questions. First, in connection with a range of 'clawback' provisions[1] the key issue is whether the company was 'insolvent' at the time (or as a result) of the relevant transaction. "Insolvent" for these purposes means:

(a) the moment at which the company becomes unable to pay its debts as they fall due - the "cash-flow" test; and/ or

(b) the moment at which the company's liabilities exceed the value of its assets - the "balance sheet" test.

1.1.2 The second question relates to the English law concept of 'wrongful trading'. This is discussed in more detail at question 2 below but for current purposes it is sufficient to note that the law tries to identify the time at which a director knew <u>or should have realised</u> that it was unreasonable to think that the company would avoid insolvent liquidation (ie. creditors were likely to go unpaid in due course). From that moment, a director will potentially be personally liable unless he does everything reasonably possible to minimise losses to creditors.

1.1.3 Besides the above statute-based considerations, it is worth mentioning in passing that a director's general duty to act in the best interests of the company has a different content when a company is 'insolvent' (in the sense that its liabilities exceed the assets). In these circumstances, the law recognises the economic reality on the company's position[2] and the directors must exercise their powers and discharge their duties with a view to minimising the potential loss to creditors as opposed to acting in the best interests of the collective body of shareholders.

1.1.4 The twilight period will, as a general rule, terminate when the formal insolvency procedure commences.

1.1.5 Generally, formal insolvency commences, for these purposes, on the date:

(a) the liquidation petition or administration application is presented in court, in the case of a court-appointed liquidation or administration;

[1] Laws entitling the insolvency office-holder (such as the liquidator or administrator) to claim assets/monies from third parties - usually in relation to transactions entered into during the twilight period - to boost the pool of assets available to pay dividends to creditors.

[2] That the shareholders' funds are exhausted and it is the creditors' money that the directors are 'playing with'.

(b) the resolution is passed by the company to wind the company up, in the case of a voluntary liquidation;

(c) the notice of intention to appoint is filed in court or, if no such notice is filed, the date on which the notice of appointment is filed in court, in the case of an administrator appointed out of court.

1.1.6 The various vulnerability periods for the English law clawbacks, being periods prior to the commencement of the formal insolvency, are as follows:

(a) preferences (eg. security, charges) - 6 months, or two years if the preferred person is connected (ss. 239 and 240(1) (a) and (b)[3]);

(b) voidable floating charges - 12 months, or two years if the holder of the floating charge is connected (s. 245(3));

(c) transactions at an undervalue (eg. guarantees) - two years (ss. 238 and 240(1)(a));

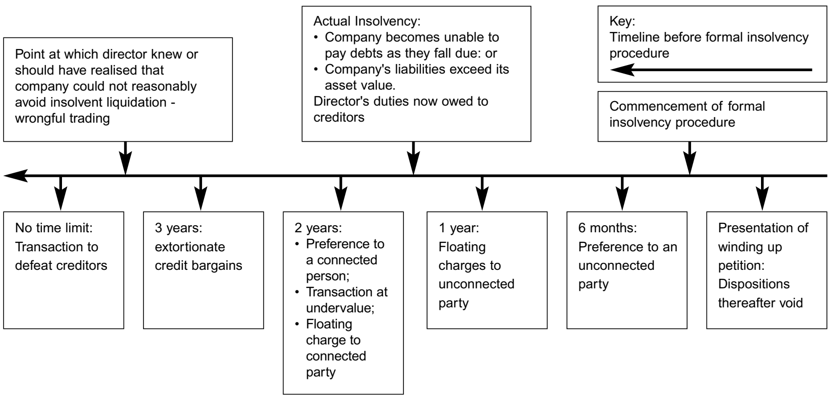
(d) extortionate credit bargains - three years (s. 244(2));

(e) transactions defrauding creditors - no time limit (s. 423);

(f) dispositions after winding up petition - from date of petition (s. 127).

Whilst these provisions are considered in more detail in reply to question 4, we set out below a "time line" summarising the statutory provisions mentioned above.

1.1.7 In relation to individual transactions the length of the period during which they can be attacked will depend upon whether or not the counterparty to the transaction was connected with the company[4].



3 All statutory references in this chapter are to the Insolvency Act 1986 (as amended) ("**IA 1986**") unless stated otherwise.

4 Effectively connected persons comprise directors (or "shadow" directors upon whose information the directors customarily act) or an "associate" of such a director or shadow director. Alternatively, a person is connected if he is simply an associate of the company. A natural person is an associate of another if they are relatives, partners, have an employer/employee relationship or trustee/beneficiary relationship. A company may also be an associate of another company if they are under common control.

1.2 Summary

1.2.1 If a company is balance sheet or cash-flow insolvent and within a vulnerability period (usually six months or two years) enters a formal insolvency procedure (e.g. liquidation or administration), transactions such as new charges, guarantees or sales of assets at less than market value may be vulnerable to attack by the liquidator or administrator (defences are discussed below in question 4).

1.2.2 Where a director knows (or should know) that insolvent liquidation is the only reasonable prospect facing the company, from that moment he is in the wrongful trading "zone" and at personal risk of liability unless, from that time, he does everything he can to minimise losses to the creditors.

QUESTION 2

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2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

2.1 Wrongful Trading[5]

(a) Prior to the 1986 insolvency legislation, the main risk to directors of personal liability for a company's debts was the law of fraudulent trading (see below). In essence, provided the director was honest (even if hopelessly misguided in his beliefs) he was unlikely to be liable for fraudulent trading. The 1986 legislation introduced a "fault"-based liability

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5 Section 214 IA 1986

for wrongful trading. The aim of the law is to catch and make liable directors who are unreasonable in their running of a company in financial difficulty[6]. The elements of wrongful trading are as follows:

(i) it applies to directors or “shadow directors”[7] of a company;

(ii) it applies where a company has at some point gone into insolvent liquidation (that is where the liabilities exceed the assets in the liquidation so that creditors go at least in part unpaid);

(iii) it applies to a director or shadow director who knew or should have realised that at some point in time there was no reasonable prospect of the company avoiding insolvent liquidation;

(iv) as to what the director should have realised, the law imposes both an objective and a subjective standard. Objectively, the law assumes a minimum standard of skill and care that can reasonably be expected of any director carrying out the functions entrusted to him. Subjectively, the law will take into account the director’s particular skills and what can be expected of him in that context in addition to the basic minimum standards;

(v) once it can be said of any director or shadow director that they knew or should have realised that insolvent liquidation was the only reasonable prospect then they are “in the wrongful trading zone” and may be liable for failure to take every step to minimise losses to creditors. Again as regards what is reasonable to expect of a director, the court will look at what minimum standard should be applied to someone carrying out their functions and also at what someone with that director’s particular skills could have done.

(b) (i) Liability is civil.

(ii) The court has a wide discretion in determining the extent of the personal liability of a director found liable for wrongful trading. However, the essence of the law is to compensate creditors for the loss caused by the director’s conduct.[8]

(iii) Although the court enjoys a wide discretion to determine the extent of a director’s personal liability, it will, in general, exercise that discretion with a view to compensating for the loss caused by the director’s conduct. On this basis there should be an element of proportionality.

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6 In general terms, English law and practice supports a “rescue culture”. On this assumption, the law of director’s duties should not seek to put too much pressure on directors in the already difficult circumstances of their company being in financial difficulty as to do so might produce excessive caution on the part of those directors leading to more formal insolvencies rather than more rescues, turnarounds and corporate recoveries.

7 See paragraphs 3.2.5 - 3.2.11 below for a full explanation of this term. For current purposes, a “shadow director” is someone in accordance with whose directions or instructions the directors of the company are accustomed to act. It will thus cover the “puppet master” who, for whatever reason, does not wish to appear on the face of the record as a director of the company but who in fact “pulls the strings” and tells the directors what to do. This would also include parent companies who in effect decide what their subsidiaries do. It should also be noted that a director under English law includes a “de-facto” director, that is someone who may not have been formerly appointed as a director but who acts in the same way as a director or is held out as such. This term is explained more fully at paragraphs 3.2.1 - 3.2.4.

8 One test for calculating the loss is to look at the amount by which the company’s assets are depleted by the conduct of the director after he became aware or ought to have become aware that there was no reasonable prospect of the company avoiding insolvent liquidation. The loss is not necessarily the amount of the new debt incurred or the cash paid out during the twilight period: In the matter of *Marini Limited (The liquidator of Marini Limited v Dickinson)* [2003 WL 1823004]

(iv) There is no specified period.

(v) The defences to wrongful trading are that first, the director or shadow director did not realise, or could not have been expected to realise, that there was no reasonable prospect of avoiding insolvent liquidation or secondly that, if insolvent liquidation of the company was the only reasonable prospect, from that moment the director/shadow director took every step to minimise the potential loss to creditors.

2.2 Fraudulent Trading[9]

(a) This applies where a company is being wound up and it is shown that the business of the company has "been carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose". The elements of the concept are therefore, as follows:

(i) there has to be an insolvent liquidation in progress[10];

(ii) there has to have been dishonesty in the running of the business (or reckless indifference as to whether or not creditors were defrauded) as that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose. The dishonesty must have been with the intention of defrauding creditors and not, for example, of avoiding some other liability;

(iii) as dishonesty is involved, the standard of proof is that of 'beyond reasonable doubt', even in a case of civil liability;

(iv) it applies to persons who are "knowingly parties" to the fraudulent trading which may be both wider and narrower than the concept of director/shadow director for wrongful trading, but it could in theory, be wide enough to catch a financier who funded the fraudulent trading knowing that it was being done dishonestly[11].

(b) (i) Liability may be criminal[12] or civil.

(ii) The court enjoys a wide discretion to compensate for the loss caused to the company by the director's conduct but it may not include a punitive element in the award of damages made[13].

(iii) As with wrongful trading, there should be an element of proportionality albeit that the court's discretion is very wide.

(iv) There is no specified period.

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9 Section 213 IA 1986

10 Except if the action for fraudulent trading is brought under section 458 Companies Act 1985.

11 *Re Bank of Credit and Commerce International SA (No.2), Banque Arabe et Internationale D'Investissement SA v Morris* [2000] All ER (D) 1437

12 Section 458 Companies Act 1985. Section 213 IA 1986 is concerned only with civil liability.

13 *Morphitis v Bernasconi* [2003] All ER (D) 33. However, a punitive element may be included if the action is brought under section 458 Companies Act 1985.

(v) The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full. It is worth noting that it was rare and remains rare for persons to be found liable for fraudulent trading. Historically, this resulted from the difficulty of proving dishonesty and, now, wrongful trading will in most sets of facts be easier to prove.

2.3 Fraud in anticipation of winding up[14]

(a) Personal liability will attach to a past or present “officer”[15] of the company who has :

(i) concealed or fraudulently removed any part of the company’s property worth £500 or more or concealed any debt owed to or from the company;

(ii) concealed, destroyed, mutilated or falsified any accounting records of the company; or

(iii) pawned, pledged or disposed of any property of the company which has been obtained on credit and not fully paid for - unless such disposal was in the ordinary course of business.

(b) If any of (i) - (iii) above are satisfied:

(i) Liability is criminal.

(ii) A person guilty of this offence is liable to imprisonment or a fine or both.

(iii) The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iv) The acts in question must have occurred either:

(A) after the commencement of the winding up; or

(B) within a 12 month period ending with the commencement of the winding up.

(v) The following defences exist :

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14 Section 206 IA 1986

15 There is no specific definition of an “officer” in either the IA 1986 of the Companies Act 1985. However, section 744 Companies Act 1985 (incorporated into the IA 1986) states that an officer in relation to a body corporate will include “a director, manager or secretary”. A “director” is defined in the IA 1986 as including any person occupying the position of a director “by whatever name called”. This will therefore include “de facto” directors. Whether a “shadow director” is included within the definition of an “officer” is likely to depend on the specific provision in question. For example, an “officer” is expressly stated to include a shadow director for those offences described in paragraphs 2.3, 2.5, 2.7 and 2.8 but not paragraphs 2.4 and 2.6. Consequently, where a “shadow director” is not expressly stated as being included by the statutory provisions it may be concluded that such a person will not be included as an “officer” for that provision. For an explanation of the definition of a “manager”, see footnote 39 to paragraph 3.3.1 below.

(A) that there was no intent to defraud or to conceal[16]; and

(B) that there was no intent to defeat the scheme of the insolvency law.

2.4 Transactions in fraud of creditors[17]

(a) This offence is made out if an officer[18] of the company:

(i) has made or caused to be made any gift or transfer of, or charge on, or has caused or connived at the levying of any execution against, the company's property, or

(ii) has concealed or removed any part of the company's property since, or within 2 months before, the date of any unsatisfied judgment or order for the payment of money obtained against the company.

(b) (i) The liability under this provision is criminal and the answers to 2.3(b) (ii) and (iii) above will apply.

(ii) The impugned transaction must have occurred during the five years before the commencement of the winding up.

(iii) Absence of intent to defraud the company's creditors amounts to a defence.

2.5 Misconduct in course of winding up[19]

(a) A past or present officer[20] of the company commits an offence if he :

(i) does not to the best of his belief fully and truly discover to the liquidator all the company's property, and how and to whom and for what consideration and when the company disposed of any part of that property not disposed of in the ordinary course of business;

(ii) does not provide to the liquidator, all of the company's property (including all books and papers) in his custody or under his control;

(iii) knowing or believing that a false debt has been proved by any person in the winding up, fails as soon as practicable to inform the liquidator; or

(iv) after the commencement of the winding up, prevents the production of any records relating to the company's property or affairs.

It is also an offence for an officer of the company to attempt to account for any part of the company's property by fictitious losses or expenses.

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16 On the question of proof, it was held in *R v Carass* [2002] 1 WLR 1714 that: "It is a defence for a person charged… to adduce evidence sufficient to raise an issue that he had no intent to defraud unless, if he does so, the prosecution proves the contrary beyond reasonable doubt" and accordingly the evidential burden was not incompatible with the right to a fair trial under the Human Rights Act 1998. See further paragraph 7.8 below.

17 Section 207 IA 1986

18 See footnote 15 above. A person will only be liable if he was an officer of the company at the time of the winding up.

19 Section 208 IA 1986

20 See footnote 15 above.

(b) If any of 2.5(a)(i) - (iv) are satisfied:

(i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.

(ii) If an officer of the company attempts to account for any part of the company's property by fictitious losses or expenses at any meeting of the company's creditors within 12 months immediately preceding the commencement of the winding up this transaction will have taken place in the twilight period. All of the other offences under this provision must have taken place when a company is being wound up.

(iii) Absence of intent to defraud is a defence to a charge under 2.5(a)(i) and (ii) above, and absence of intent to conceal the company's state of affairs or to defeat the law is a defence to a charge under 2.5(a)(iv) above.

2.6 Falsification of company's books[21]

(a) An officer[22] of a company commits an offence if, when the company is being wound up, he destroys, mutilates, alters or falsifies any books, papers or securities, or makes or is privy to the making of any false or fraudulent entry in any register, book of account or document belonging to the company with intent to defraud or deceive any person.

(b) If the conditions in 2.6(a) are satisfied:

(i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.

(ii) This offence applies when a company is being wound up.

(iii) Absence of intent to defraud or deceive will amount to a defence.

2.7 Material omissions from statement relating to company's affairs[23]

(a) A past or present officer[24] of the company commits an offence if he makes any material omission in any statement relating to the company's affairs.

(b) If the requirements of 2.7(a) are satisfied:

(i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.

(ii) This offence applies to statements made when a company is being wound up.

(iii) Absence of intent to defraud is a defence.

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21 Section 209 IA 1986
22 See footnote 15 above.
23 Section 210 IA 1986
24 See footnote 15 above.

2.8 False representations to creditors[25]

(a) Any past or present officer[26] of the company commits an offence if he makes any false representation or commits any other fraud for the purpose of obtaining the consent of the company's creditors or any of them to an agreement with reference to the company's affairs or to the winding up.

(b) If the requirements of 2.8(a) are satisfied:

(i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.

(ii) This offence applies to false representations made when a company is being wound up and at any time prior to the winding up.

(iii) Absence of intent to mislead the company's creditors into giving their consent on the basis of a false premise is a defence to this charge.

2.9 Misfeasance[27]

(a) A past or present officer[28] of the company, in liquidation, who has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty including negligence in relation to the company the direct consequence of which is misapplication or loss of assets will incur liability.

(b) (i) The liability for this offence is civil.

(ii) The court may order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the court sees fit or to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks fit.

(iii) The court has wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.

(iv) Aside from Statute of Limitations considerations there is no time period within which the impugned act must have occurred in order for liability to attach.

(v) There is a defence where the director has acted honestly and reasonably and the court concludes that he ought fairly to be excused[29].

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25 Section 211 IA 1986
26 See footnote 15 above.
27 Section 212 IA 1986
28 See footnote 15 above.
29 Section 727 Companies Act 1985

2.10 Re-using a prohibited company name[30]

(a) Any person who was either a director or shadow director of the company at any time during the period of 12 months ending with the company's liquidation is prohibited from being concerned in another company which uses the insolvent company's name or a name similar to that name so as to suggest an association with it. The extent of the prohibition is that, except with the leave of the court, a director is not permitted for a period of five years from the date of the commencement of the relevant liquidation:

(i) to be a director of any company that is known by a "prohibited name";

(ii) in any way, whether directly or indirectly, to be concerned or take part in the promotion, formation or management of such a company; or

(iii) in any way, whether directly or indirectly, to be concerned with or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.

A "prohibited name" is;

(i) a name by which the company which went into insolvent liquidation was known at any time during the 12 months prior to the commencement of the liquidation; or

(ii) a name so similar to that name as to suggest an association with the company in insolvent liquidation. This would include a trading name as well as a registered name.

(b) (i) Liability is both criminal[31]and civil[32].

(ii) (A) Personal liability can be incurred in respect of such debts and other liabilities of the new company as are incurred at the time when that person was involved in the management of the new company; and

(B) in relation to a person who acts on or was willing to act on instructions given by someone whom he knows to be acting in contravention of section 216, personal liability can be incurred in respect of such debts and other liabilities of the new company as are incurred at a time when he was acting on or was willing to act on those instructions.

(iii) Liability may arise where the re-use of the company name took place without the consent of the court during the period of 5 years beginning with the day on which the company went into liquidation if the re-used name is the same as the name used by the insolvent

30 Sections 216 and 217 IA 1986
31 Section 216 IA 1986
32 Section 217 IA 1986

company during the 12 month period ending with the liquidation or is so similar to that name as to suggest an association with it.

(iv) The court is empowered to grant dispensations from the prohibition imposed under this provision if the insolvency is not linked with any blameworthy conduct on the part of the director. Exemptions are also permitted where:

(A) the whole, or substantially the whole of the business of an insolvent company is acquired by a successor company and the liquidator gives the prescribed notice[33];

(B) for an interim period, where an application is made to the court[34]; and

(C) where the new company has been known by the name in question for at least 12 months prior to the liquidation and has not been a dormant company[35].

2.11 Destroying, mutilating etc. company documents[36]

(a) Any officer[37] of a company who destroys, mutilates or falsifies or is privy to the destruction, mutilation or falsification of, a document affecting or relating to the property or affairs of the company, or makes or is privy to the making of a false entry in such documents is guilty of an offence . Furthermore, any such person who fraudulently either parts with, alters or makes an omission in such a document is likewise guilty of an offence.

(b) (i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.

(ii) There is no time period within which the relevant act must have been undertaken in order for liability to attach to a director.

(iii) Absence of an intention to conceal the company's state of affairs or to defeat the law is a defence.

2.12 General fiduciary duties owed to the company

(a) It is an established rule that insofar as a director of a company is bound by fiduciary duties under the general law, those duties are owed to the company only. The form in which a director's duties are expressed is that of a number of general legal and statutory rules, varying greatly in the range of application and at many points overlapping with each other[38]. The duties include:

(i) the duty to act bona fide in the interests of the company[39];

(ii) the duty to act for proper purposes;

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33 Rule 4.228 Insolvency Rules ("**IR**") 1986
34 Rule 4.229 IR 1986
35 Rule 4.230 IR 1986
36 Section 450 Companies Act 1985
37 See footnote 15 above
38 White Paper CM555316 16 July 2002 "Modernising Company Law" proposes to codify the duties of directors in a new Companies Bill. The nature of a director's fiduciary duties would not change.
39 This includes a duty to act in the best interests of employees: s309(1) Companies Act 1985

(iii) the duties as trustee of company property which is in the hands or control of directors;

(iv) the duty to avoid a conflict of interest and duty;

(v) the duty to disclose interests in contracts at general law;

(vi) the duties imposed by various provisions in the Companies Act 1985 as to directors' contracts; and

(vii) the duty not to make secret profits.

Once the company is insolvent, however, the interests of the creditors override those of the shareholders in the company. Thereafter the directors' duties are subject to an overriding duty to have regard to the interests of the general creditors of the insolvent company.

(b) (i) Liability for breach of these duties is civil.

(ii) Liability is for all loss to the company occasioned by the breach of duty subject to the usual rules of recoverability based on considerations of causation and remoteness of damage.

(iii) Liability for breach of general fiduciary duty is joint and several for the entire loss in the first instance. The Court can, however, allocate contributions as between the defendant directors taking into consideration their respective levels of culpability for what has taken place[40].

(iv) Subject to Statute of Limitation considerations there is no time limit within which action may be taken against a director.

(v) The Court has discretion to relieve the director either wholly or partly from liability on such terms as it thinks fit if:

(A) he acted honestly;

(B) he acted reasonably; and

(C) he ought fairly to be excused from liability in all the circumstances[41].

2.13 Common law duties of skill and care

(a) A director in carrying out his duties:

(i) is required to exhibit such a degree of skill as may reasonably be expected from a person with his knowledge and experience or that may reasonably be expected of a person in his position; and

(ii) to exercise such skill and care as an ordinary man would bring to bear on his own affairs.

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40 Section 1, Civil Liability (Contribution) Act 1978

41 Section 727, Companies Act 1985

As with fiduciary duties, a director's common law duties are subject to an overriding duty to have regard to the interests of the company's general creditors once it becomes insolvent.

(b) (i) Liability for breach of these duties is civil.

(ii) The court will award damages to compensate the company for loss that has been suffered as a result of the director's breach of duty[42].

(iii) Liability for all of the loss suffered by the company because of the breach of duty will be joint and several. The Court can allocate contributions as between the defendant directors based on their respective levels of culpability for the loss.[43]

(iv) Subject to Statute of Limitation considerations there is no time limit within which action may be taken against a director.

(v) The court has discretion to relieve the director either wholly or partly from liability on such terms as it thinks fit if:

(A) he acted honestly;
(B) he acted reasonably; and
(C) he ought fairly to be excused from liability in all the circumstances.[44]

2.14 Standard of fiduciary and common law duties owed by executive and non-executive directors

2.14.1 In applying the standards required by the foregoing fiduciary and common law duties, no distinction is drawn between the position of an executive and a non-executive director. However, the reference in the test set out in paragraph 2.13(a)(i) to "a person in his position" does allow the Court to take into account such matters as, for example, the fact that a non-executive director's functions are discharged on a part-time basis.[45]

2.14.2 An executive director will normally have a service contract which may be the source of additional duties. Section 310 of the Companies Act 1985 prohibits any provisions in a contract or in the company's memorandum or articles of association which attempt to exonerate or indemnify the director from liability. It is also not possible to create an exhaustive list in either the director's service contract or in the company's memorandum or articles to specify exactly what are the director's duties. The duties owed by a director to the company can be increased by reference to the terms of the service contract but they cannot be diminished.

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40 Section 1, Civil Liability (Contribution) Act 1978

41 Section 727, Companies Act 1985

42 In *West Mercia Safetywear v Dodd* [1988] BCLC 250 the court of appeal upheld a judgment ordering a misfeasant director to repay the value of a transfer by way of fraudulent preference.
In this case, the court effectively provided a "clawback" to recover the value of the amount wrongfully transferred.

43 Section 1, Civil Liability (Contribution) Act 1978

44 Section 727, Companies Act 1985

45 In *Equitable Life Assurance Society v Bowley* [2003] B.C.C. 829, it was acknowledged that :"There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so." The full hearing of this case is awaited and is likely to provide clarification on the role and standards expected of non-executive directors.

2.14.3 In the absence of an employment contract the non-executive will clearly not owe any contractual duties of care to the company. It is accepted that the non-executive may rely on his co-directors to carry out various tasks and functions. This does not, however, abrogate his responsibility to inform himself about the company's affairs and to join with his co-directors in supervising and controlling them. The non-executive may rely on a co-director to the extent that any matter lies within the co-director's sphere of responsibility given the way the business of the company is organised and there exist no reasons for supposing that this reliance is misplaced. But note that the extent to which a non-executive may reasonably rely on the executive directors and other professionals to perform his duties is an area in which the law is developing and has been described as plainly "fact sensitive".[46]

2.15 Incurring further credit

2.15.1 The incurring of further credit may be the factual matrix for one of the grounds of liability discussed above, for example (and most probably) wrongful trading. For further discussion please see answer to Question 11 below.

2.16 Liability of directors to disqualification for acts done in the 'twilight zone'

2.16.1 The relevant legislation is the Company Directors Disqualification Act 1986 ("**CDDA 1986**"), under which a court may order that a person should be disqualified from being a director of a company or from taking part in its management (except with the leave of the court), for a period of up to fifteen years. While insolvency of the company concerned is not a prerequisite for the application of some of the grounds of disqualification set out in the CDDA 1986[47], in practice almost all disqualification orders are made on the basis of conduct evidencing a person's 'unfitness' to act as director[48], for which it is a requirement that the person concerned has been a director of a company which has gone into insolvent liquidation or become the subject of other insolvency proceedings such as administration or administrative receivership. There is no provision in the CDDA 1986 for the automatic disqualification. Disqualification orders can also be made where the person concerned has been held liable to make a contribution to the assets of a company in liquidation on the grounds of fraudulent or wrongful trading[49].

2.16.2 Since 1 April 2001, directors against whom disqualification proceedings would have otherwise been brought on the basis of 'unfitness' can voluntarily give an undertaking instead that they will not act as a director or be involved in the formation of a company for a set period of time.[50]

2.16.3 Apart from the case where a disqualification order is made as part of the sentence imposed following conviction for a crime, disqualification proceedings have been consistently held to be civil and not criminal in nature, both by UK courts and by the European Court of Human Rights. (See further paragraph 7.9.3 below.) There is also, generally speaking, no anterior time

46 *Equitable Life Assurance Society v Bowley* [2003] B.C.C. 829.

47 For example, conviction of an indictable offence in connection with the management of a company (section 2): persistent contravention of companies legislation (sections 3 and 5).

48 Section 6 CDDA 1986.

49 Section 10 CDDA 1986. It is even possible for the disqualification proceedings and the wrongful trading allegations to be heard at the same hearing.

50 Section 1A CDDA 1996.

limit in respect of the conduct of a director which can be examined. The only exception is where the disqualification order follows consequentially upon some other court ruling, such as a finding of wrongful trading, to which a limitation period applies.

Acts potentially giving rise to a disqualification order

2.16.4 As noted above, in all but a few instances, the ground on which an order is made is a finding of 'unfitness' based on the person's conduct in relation to one or more companies which have become insolvent. There is no statutory definition of 'unfitness'. Instead, the CDDA 1986 sets out in a schedule a list of typical factors on which a finding of unfitness may be based, such as breach of fiduciary duty by the director (see above), misapplication of moneys and failing to keep proper accounts and make returns. More pertinently, the list also includes various acts which will usually be linked with the company's insolvency – for example, the person's responsibility for the company entering into any transaction liable to be set aside as being at an undervalue, a preference or in fraud of creditors. However, the list of matters referred to in the schedule is not exhaustive, and in practice other types of conduct which commonly feature in disqualification cases include continuing to trade when the director knew, or should have known, that the company was insolvent, failing to account to the Inland Revenue for tax and social security moneys deducted from employees' wages, following a policy of discriminatory payment between creditors, drawing excessive remuneration and making excessive expenses claims.

2.16.5 In determining whether a director is unfit, the court considers the cumulative effect of the allegations as are proved against him.

2.16.6 Although it is a common feature in most cases that the director has displayed a lack of commercial probity, gross negligence or serious incompetence, this is not always so. Following the collapse of the Barings banking group, for instance, many of its most senior board members were disqualified because they had not ensured that there were adequate internal control and monitoring systems in place.

2.16.7 That said, the courts have recently expressed caution at holding that a director is unfit based on conduct that does not amount to a breach of any duty (contractual, tortious, statutory or equitable) to anyone, and is not dishonest.[51]

Length of disqualification

2.16.8 The period of disqualification imposed is fixed in the discretion of the court by reference to the person's own degree of responsibility and blameworthiness (subject, in the case of disqualification based on unfitness, to a minimum period of two years). In fixing the length of disqualification, the court may also have regard to mitigating factors such as the person's general good reputation, his age and state of health, whether he has been influenced by others, and his frankness with the court. The Court of Appeal has laid down guidelines which divide the cases into three categories:

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51 *Secretary of State for Trade and Industry v Goldberg* [2003] All ER (D) 369

(a) a period of from 10 to 15 years is merited only in the most serious cases, and in particular for a person who faces disqualification for a second time[52];

(b) two to five years' disqualification is justified where the case is, relatively, not very serious[53]; and

(c) a middle 'bracket' of six to ten years for cases falling between (a) and (b)[54]. Statistics show that most of the orders made range from three to seven years.

An appeal is in principle available against the imposition of a disqualification order, or against its duration. In some cases, however, an appeal will lie only with the leave of the court which made the order or of the appeal court itself. As noted in paragraph 2.16.1 above, a disqualification order may be made as part of the sentence imposed by a criminal court, or consequentially upon a finding of fraudulent or wrongful trading leading to an order to pay compensation. But the converse is not the case: where proceedings are commenced for the purpose of obtaining a disqualification order, there is no jurisdiction to impose a criminal or civil penalty in addition.

2.16.9 The same period of disqualification (two to fifteen years) applies in relation to disqualification undertakings but given the director's co-operative approach, one would expect a slightly lesser period of disqualification to be agreed upon in practice.

2.16.10 Other than those who have been formally appointed directors, and save where the conduct on which disqualification is based is a criminal offence[55] or fraudulent trading[56], disqualification may only be made against de facto directors, shadow directors and former directors. A financing bank, holding company or other third party (including counterparties to voidable transactions) will not be liable unless its conduct brings it within one of these three categories.

2.16.11 Enforcement is in practice (and, in the case of disqualification based on 'unfitness', by express provision) almost entirely in the hands of government or regulatory authorities. The only likely exception would be where a disqualification order is made incidentally to a finding of wrongful trading, in which case the proceedings would have been instituted by the company's liquidator. Office-holders, such as liquidators, are placed by statute under an obligation to submit a report to the appropriate government agency on the conduct of every director and former director of a company which has become insolvent, with a view to determining whether there is a case for disqualification proceedings on the ground of unfitness to be instituted.

Duty to co-operate

2.16.12 Directors and others concerned in an insolvency are placed under a general duty to provide information to the liquidator or other office-holder and to co-operate

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52 *Official Receiver v Stern* [2001] All ER (D) 278 is an example.
53 *Secretary of State for Trade and Industry v Goldberg & McAvoy* [2003] All ER (D) 369 is an example.
54 *In the matter of Skyward Builders plc (O.R. v Mullarkey)* [2002] All ER (D) 367 is an example.
55 Section 2 CDDA 1986
56 Sections 4 and 10 CDDA 1986

with him[57] and by other legislation to give information to government officers investigating the affairs of a company. A detailed summary of a director's duties to co-operate and the relevant provisions are set out in question 7 below.

Limitation periods

2.16.13 Disqualification proceedings on the ground of unfitness may only be commenced within two years from the day when the company 'became insolvent' (i.e. went into insolvent liquidation, administration or administrative receivership). The court may, exceptionally, extend this period. In regard to disqualification proceedings based on other grounds, there is no time limit prescribed.

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Introduction

3.1.1 Subject to the particular act or offence in question, English law may impose liability on a potentially wide variety of persons who have been involved in the management of a company in some way during the twilight period. Although the management of a company's affairs is primarily undertaken by its directors, English law has an extended definition of this term which is capable of including a variety of persons who, while not formally appointed as directors may have played a role in the company's management during the twilight period. Such persons may be held personally liable in respect of certain acts taken by them which have caused loss to the company and its creditors during this time. In particular, English law will impose personal liability on "shadow" and "de facto" directors in certain circumstances. Both these concepts are explained below. In addition, officers of the company who have been guilty of wrong-doing may also be liable in damages to the company thereby increasing the fund available to meet the claims of the company's creditors.

[57] Sections 235 and 236 IA 1986

3.1.2 Finally, a third party, even if not involved either directly or indirectly with the management of the company, may be liable to return assets to the company as a result of being a party to a transaction at undervalue, a preference or a transaction defrauding creditors. In addition, under general equitable principles of English law, a third party who had knowledge of a breach of duty by a director when entering into a transaction and either fraudulently assisted in that breach and/or received property from the company with knowledge of that breach may be held liable as a "constructive" trustee of such property and liable to return it or to pay compensation to the company. A table summarising those, other than the directors of a company, who may be liable in respect of actions taken in the twilight period is set out at paragraph 3.5 below.

3.2 De facto and shadow directors

3.2.1 At both common law and under statute, English law has widened the scope of those who may be regarded as directors or treated in the same way as directors. In particular, the common law has developed the concept of "de facto" directors - directors who, notwithstanding that they may not have technically been appointed as directors as a matter of company law are, as a result of their actions and the functions they carry out, treated as directors. Secondly, under statute and to catch figures who, although not on the board nor apparently taking day to day decisions at the company, are in fact pulling the strings from behind the scenes, there is the concept of the "shadow director".

De facto directors

3.2.2 A de facto director is one who acts as a director and is treated as such by the rest of the board even though he may never have been formally appointed a director or there is a defect in the technicalities of his appointment (for example he was appointed at a meeting at which a quorum was not present). "Director" is defined in section 741(1) of the Companies Act 1985 to include any person occupying the position of director, by whatever name called. Thus, if someone were to be called an "observer" on the board but in fact took director-type decisions, then the court may be prepared to conclude that that person is a de facto director.

3.2.3 De facto directors owe the same duties to the company as directors who have been formally appointed. However, they may be further liable if they dispose of company property because they are wrongdoers. Unless the shareholders in general meeting resolve to ratify the disposals, they are liable to compensate the company for the value of the assets wrongfully disposed of. This right of action vests in the company.

3.2.4 De facto directors are able to bind the company in making contracts with third parties acting in good faith. They are not personally liable under those contracts under principles of agency law, but may be liable in damages for breach of an implied warranty of authority if they can be deemed to have warranted that they had authority to act on behalf of the company when no such authority existed.

Shadow directors

3.2.5 A shadow director is defined in section 251 of IA 1986 and section 22(5) of the CDDA 1986 as: “a person in accordance with whose directions or instructions the directors of a company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity).”

There is a similar definition for Companies Act purposes in section 741(2) of the Companies Act 1985.

3.2.6 There are a number of elements to note in the definition:

Person	can mean an individual or a corporation
Directions or instructions	these are clearly more than mere suggestions but may include non-professional advice in certain circumstances
Accustomed to act	there must be a pattern to the directions or instructions and occasional directions will not make someone a shadow director. However, again, the point at which conduct becomes habitual will depend upon the facts of a particular case
Advice given...in a professional capacity	this was thought originally to have been inserted to protect those such as solicitors who may sit in on board meetings and/or advise the board of a company but clearly it applies to all advice of a professional nature

In practice, what conduct makes someone a shadow director?

3.2.7 After the 1986 Insolvency Act was passed, there was initial concern expressed by banks and others advising banks that banks, in particular, were at risk of being held to be shadow directors. However, various extra-judicial pronouncements, case law and official guidance from the Insolvency Service have established a number of guidelines in connection with the type of conduct that may make someone a shadow director. In respect of the actions banks are likely to engage in when a customer is in financial difficulty, it is unlikely that the following actions will lead to a bank being found to be a shadow director:

(a) sending an investigating team to review the company’s current financial condition;

(b) requiring a reduction in existing overdraft facilities;

(c) requiring security or further security in respect of amounts outstanding;

(d) calling for information, valuations of fixed assets, accounts, cash flow forecasts, etc;

(e) requesting the customer's proposals for the reduction of the overdraft, including the submission of a business plan, schedule of proposed sales, etc; and

(f) advising on the desirability of strengthening management, seeking fresh capital, etc.

3.2.8 In addition to the above points, the disqualification unit of The Insolvency Service has indicated that it will look at the following grounds to see if an individual has acted as a de facto or shadow director:

(a) whether the person was a signatory to the bank account;

(b) whether memoranda of interviews with bank officials point toward shadow directorship or de facto directorship;

(c) whether there is evidence of the person ordering goods or services;

(d) whether there is any written documentation which the person has signed as a director;

(e) whether he has been attending board meetings;

(f) whether there is evidence from creditors or employees that he has acted as such; and

(g) where the company has gone into liquidation, whether he is the only person able to give the insolvency practitioner (certain) information.

3.2.9 A review of the statutory definition of and the requirements for shadow directorship was provided by the Court of Appeal in *SSTI v Deverell* (2000). Lord Justice Morritt (delivering the unanimous decision of the Court), after reviewing the previous case law, set out a number of propositions concerning the statutory definition of a shadow director.

(a) The term "shadow director" should not be narrowly construed so as to limit Parliament's intention to protect the public from those involved in the management of a company which had become insolvent;

(b) The purpose of the Company Directors Disqualification Act 1986 legislation was to identify those, other than professional advisers, who had exercised "real influence in the corporate affairs of the company" and it was not necessary that such influence should be exercised over the whole field of a company's corporate activities;

(c) Classifying a particular communication from a shadow director as a direction or instruction, whether by words or conduct, must be objectively ascertained by the court in the light of all available evidence. It is not necessary to prove that it was understood or expected, as between the giver and receiver of the relevant instruction or direction, that the instruction or direction would be followed. In many cases it will suffice simply to show that the instruction or direction was subsequently followed. Whether the parties label the communication as an "instruction" or "direction" will be no more than a factor that the court will take into account;

(d) Non-professional advice may fall within the statutory description of an "instruction" or "direction". The fact that the legislation expressly includes a proviso excluding advice provided in a professional capacity indicates that general non-professional advice may be included. The Court stated that "the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance". In summary, "frequent non-professional advice usually acted on is sufficient";

(e) There is no requirement for the properly appointed directors to whom directions or instructions are given to cast themselves in a subservient role or to specifically have surrendered their discretion. The Court concluded that such a requirement would be to add an unnecessary gloss to the statutory requirement that the board were "accustomed to act in accordance with" such directions or instructions;

(f) The use of epithets or descriptions in place of the actual statutory definition of a shadow director were not always helpful. For example, to describe the board of directors as the "cat's paw, puppet or dancer to the tune of the shadow director implies a degree of control both of quality and extent over the corporate field in excess of what the statutory definition requires"; and

(g) There is no requirement for a shadow director to "lurk in the shadows": it may occur but it is not an essential ingredient to the recognition of a shadow director. The Court provided the example of a person resident abroad who owns all the shares in a company but chooses to operate that company through a local board of directors situated in the place of incorporation of the company. If, from time to time, the shareholder, to the knowledge of all of those to whom it may be of concern, gives directions to the board of directors but takes no part in the actual management of the company himself, he may well be a shadow director even though he makes no attempt to hide the part he plays in directing the affairs of the company.

3.2.10 It is clear that in recent years the courts have sought to move away from a narrow legalistic approach to the requirements of shadow directorship. In each case, regard must be had to the frequency of the advice or instructions (whether over the running of the business as a whole or merely in specific areas) and whether such advice was usually acted upon (whether or not the directors have expressly or impliedly surrendered their discretion) so that it may be said that the third party in question exerted a "real influence over the affairs of the company".

3.2.11 Administrative receivers and administrators will not be shadow directors as they assume the functions of the directors but do not instruct the directors.

3.3 Officers

3.3.1 Liability for many of the acts identified in Question 2 above is often imposed on an "officer" of the company. As noted above[58], there is no specific statutory definition of this term. Instead, the different persons who are

[58] See explanation of definition of "officer" in footnote 15 to paragraph 2.3 above.

covered by the term will usually depend on the statutory provision in question. Section 744 of the Companies Act 1985 states that the term *includes* a director, manager[59] or secretary of a company. Others who may be officers of a company include auditors[60] and administrators. Receivers, including administrative receivers, will not be officers of a company[61].

3.4 Other third parties who may be held liable

3.4.1 Administrators, liquidators and administrative receivers may be found liable for misfeasance or breach of duty owed to the company[62] (although necessarily this will be in respect of the post-twilight period).

3.4.2 Third parties who receive property as a result of a transaction at undervalue, preference or as a result of a transaction defrauding creditors will be liable either to return such property or provide such compensation as the court may order. In addition, where a company is being wound up by the court, any disposal of the company's property made without the court's approval after the winding up order has been made will be void.

3.4.3 Any persons who are knowingly parties to the carrying on of a business with intent to defraud creditors may be liable for fraudulent trading.[63] It is not necessary for that person to have performed a managerial or controlling role within the company; it will be enough if that person has participated in the fraudulent trading, in the sense of taking some positive step. An employee who merely carries out orders will not be liable.[64]

3.4.4 It is also possible for any third party who has dishonestly assisted in a breach of duty by a director or other officer of a company or knowingly received property arising from such breach to be liable in respect of any loss arising. The legal rules relating to knowing assistance and/or receipt of property are applicable in any circumstance and not only in respect of actions taken during the twilight period. The power of the English court to apply these rules arises under its general equitable jurisdiction.

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59 The concept of a "manager" is not defined in either the Companies Act 1985 or the Insolvency Act 1986. It is not clear whether a person would need to have been appointed to a post carrying managerial responsibilities or whether it is sufficient that he has taken some part in the management of a company's business even at a junior level. In *Re a Company No.00996 of 1979* [1980] Ch 138 Shaw LJ stated: "[Any] person who in the affairs of the Company exercises a supervisory control which reflects the general policy of the Company for the time being or which is related to the general administration of the Company is in this sphere of management. He need not be a member of the board of directors. He need not be subject to specific instructions from the board." Consequently, the definition is potentially a wide one especially in relation to those provisions (such as section 212 IA 1986) which place liability on any person who has been "concerned in the … management of the Company".

60 See *Re Thomas Gerrad & Son Limited* [1968] Ch 455. However, it is unclear whether an auditor would be considered an officer in all circumstances and he is expressly excluded from the definitions in some statutory provisions.

61 *Re B Johnson & Co. (Builders) Limited* [1955] Ch 634.

62 In respect of administrators, liability is under paragraph 75 of Schedule B1 to the IA 1986. In respect of liquidators and administrative receivers, liability is under section 212 IA 1986; see paragraph 2.9 above. The two provisions are essentially the same except under the former, the company need not be in liquidation.

63 Section 213(2) IA 1986; see paragraph 2.2 above.

64 *BCCI v Christopher Morris* [2000] All ER (D) 143

3.5 Actions for which liability may attach to persons not formally appointed as directors

Offence/activity	Persons liable	Extent of liability
Wrongful trading	Past and present shadow directors for the period during which wrongful trading occurred	Same as for director
Fraudulent trading	Any person who was knowingly a party to the carrying on of the business for a fraudulent purpose (this will include persons dealing with the company who receive property with knowledge of the fraud)	Same as for director
Fraud in anticipation of winding-up	Any past or present officer (incl. a shadow director) and third party recipient with knowledge of property obtained by fraud	Same as for director; third party with knowledge of fraud liable to the extent of property received
Transactions in fraud of creditors	Officers of company at time of fraud	Same as for director
Misconduct in course of winding-up	Any past or present officer (incl. shadow director)	Same as for director
Falsification of company's books	Officer of the company	Same as for director
Material omission from statement relating to company's affairs	Any past or present officer (incl. shadow director)	Same as for director
False representation to creditors	Any past or present officer (incl. shadow director)	Same as for director
Misfeasance	Any past or present officer; liquidator; administrator; administrative receiver; any person involved in the formation, promotion or management of the company (may incl. shadow directors)	Same as for director
Restriction on re-use of company name	Shadow director within 12 months of company's liquidation	Same as for director
Personal liability for contravention of restriction on re-use of company name	Any person involved in the management of the company	Same as for director

Offence/activity	Persons liable	Extent of liability
Transaction at undervalue	Recipient of property received	Return of property received and/or pay compensation to the company
Preference	Recipient of preference	Return of property received or removal of specific benefit received
Transaction defrauding creditors	Recipient of property	Return of property received
Dishonestly assisting or knowingly receiving property or assets in breach of duty	Any person with the requisite degree of "knowledge" who knowingly assists in a breach of duty owed by a person to a company or knowingly receives property from a breach of duty owed to the company	Where requisite knowledge and other applicable conditions are satisfied a person may be held to be a constructive trustee of the property and required to return such property or pay compensation equal to the loss caused.

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Introduction

4.1.1 Most legal systems can be expected to have rules which seek to overturn transactions operating to the detriment of a company and/or are unfairly beneficial to a counterparty, which are entered into during the twilight period if a formal insolvency actually occurs.[65] This reflects the weakened state of a

65 Some may apply whether or not a formal insolvency actually occurs - e.g. transactions defrauding creditors, (section 423 IA 1986) and transactions in breach of a director's duties but most often the catalyst for challenge is the commencement of a formal insolvency procedure. Some may apply whenever the relevant transaction was entered into (i.e. not just within say 6 months or 2 years before the insolvency commenced) - e.g. disclaimer of onerous property by the liquidator and voidness of charges not registered at Companies House.

company which is in financial difficulty and the inequality of bargaining power that may have arisen.

4.1.2 Sensible insolvency laws should strike a balance between ensuring adequate 'clawback' powers for insolvency office-holders such as liquidators while not preventing a company effecting transactions which maximise its chances of survival where that is for the benefit of creditors.

4.2 Summary of heads of challenge

4.2.1 The potential heads of challenge which may lead to transactions being set aside relate to transactions[66]:

(a) which are at an undervalue;

(b) which are preferences;

(c) defrauding creditors;

(d) which constitute extortionate credit bargains;

(e) comprising floating charges given for past value;

(f) in breach of the directors' fiduciary duties;

or which involve the following elements:

(g) onerous property;

(h) dispositions of the company's property made after the commencement of winding-up;

(i) unregistered charges.

We look briefly at each head in turn.

4.3 Transactions at an undervalue[67]

4.3.1 By way of overview a transaction at an undervalue is a transaction entered into at a time when the company is insolvent and it later goes into administration or liquidation and is one where the company receives significantly less than it gives and there are no counterbalancing reasons why it benefits the company. The attack may be made by an administrator or liquidator and the court has a range of options if it finds there has been a transaction at an undervalue in order to restore the position.

Conditions for setting aside a transaction at undervalue

4.3.2 The court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied:

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66 The heads of challenge in 4.2.1(g) and (h) do not apply in respect of market contracts or margin contracts effected by an exchange or clearing house - Companies Act 1989, s164.

67 Section 238 IA 1986. All statutory references in this question 4 are to the IA 1986 (as amended) unless stated otherwise.

(1) The company is in liquidation or administration and an application is made by the liquidator or administrator (s 238(1) and (2)).

(2) The company entered into a transaction at an undervalue either:

(a) within the two years ending with the "onset of insolvency"; or

(b) between the time of presentation of an administration application and the making of an administration order on that application; or

(c) between the filing with the court of a copy of a notice of intention to appoint an administrator and the appointment of an administrator (ss 238(2), 240(1)((a), (c), (d)).

The "onset of insolvency" is not a reference to the company's financial state. It is defined, depending upon the circumstances, as:

(a) the date on which an administration application is filed in court; or

(b) the date of the filing in court of a copy of a notice of intention to appoint an administrator; or

(c) where no such notice of intention to appoint is filed at court, the date on which the notice of appointment is filed at court; or

(d) the passing of a voluntary winding up resolution or the presentation of a winding up petition (except where the company has previously been in administration that has ceased to have effect or where the administration proceedings were opened as territorial proceedings under the EC Regulation on Insolvency Proceedings and are now being converted into secondary winding up proceedings pursuant to Article 37 of the EC Regulation, in which case, (a), (b) or (c), as appropriate, will be treated as the onset of insolvency) (s 240(3)).

(3) The company was unable to pay its debts within the meaning of s 123 IA 1986 (see answer to question 1 but, briefly, this means that it fails either the cashflow or the balance-sheet test of insolvency) either: at the time of entering into the transaction or in consequence of entering into it (s 240(2)). Where the creditor is a person 'connected with' the company (see answer to question 1), there is a rebuttable presumption of the company's inability to pay its debts (s 240(2)).

What is a transaction at an undervalue?

4.3.3 A company enters into a transaction with a person at an undervalue if it:

(1) makes a gift to that person; or

(2) otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or

(3) enters into a transaction with that person for a consideration the value of which is significantly less than the value, in money or money's worth, of the consideration provided by the company (s 238(4)).

4.3.4 A transaction is defined as including a gift, agreement or arrangement, and references to entering into a transaction are to be construed accordingly (s 436). In *Phillips v Brewin Dolphin* [2001] UKHL 2, [2001] 1 All ER 673 the court accepted that as between the company and the counterparty or counterparties it will look beyond the form to the substance in ascertaining what constitutes the transaction. Thus two contracts between the company and the counterparty may, if sufficiently intertwined, be viewed as a whole.

4.3.5 The value of the consideration must be assessed as at the date the transaction was entered into. If, at that date, value was dependent on the occurrence or non-occurrence of some event and that event occurred before the assessment of value, then regard might be had to it but regard should also be had to all other matters relevant to the determination of value. Subsequent events should not be taken into account unless and to the extent that they were both relevant and foreseeable at the time the transaction was entered into.[68]

4.3.6 In valuing the consideration, the incidental value to the transferee must also be considered. For example, a lease at full market rent may nevertheless be a transaction at an undervalue if the lease has a ransom or surrender value (for example, because it is a protected tenancy under the Agricultural Holdings Act 1986): *Agricultural Mortgage Corp plc v Woodward* [1994] BCC 688. In other words, the real value of any incidental benefits to the transferee (and the real value of what the company is providing in exchange) have to be considered. In *Phillips v Brewin Dolphin* [2001] UKHL 2, [2001] 1 All ER 673 it was held that identification of the consideration is a question of fact and that the consideration for a transaction can include the benefit of a covenant given by a third party, where a company agrees to sell an asset to A on terms that B agrees to enter into some collateral agreement with the company. However, the value of B's covenant in money or money's worth must be determined by discounting the present value of future payments by the probability of non-payment

Defences

4.3.7 The court may not make an order under this provision if it is satisfied:

(1) that the company which entered into the transaction did so in good faith and for the purpose of carrying out its business; and

(2) that at the time it did so there were reasonable grounds for believing that the transaction would benefit the company (s 238(5)).

Further, the court may not make an order which would prejudice certain purchasers in good faith and for value. There are specific rules governing the meaning of good faith in the context of notice of the circumstances giving rise to the undervalue (s241(2) and (3)).

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[68] *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 All ER 673 and *Re Thoars (deceased) (Reid v Ramlort Ltd [2002] All ER (D) 235.*

Examples of financial transaction that may fall within the section

4.3.8 In the leading case on this issue (*Re M C Bacon* (No.1) [1990] BCC 78) the court held that the creation of security over a company's assets as security for a company's own liabilities could not be a transaction at an undervalue. The provision required, it was held, a comparison to be made between the value of the consideration obtained by the company and the value of the consideration provided by the company. Both values have to be measured in money or money's worth and have to be considered from the company's point of view. The mere creation of security over the company's assets does not deplete them or diminish their value. Loss by the company of the ability to apply the proceeds of the assets otherwise than in satisfaction of the secured debt is not capable of valuation in money terms, nor is the consideration received by the company in return.

4.3.9 A guarantee by a company to a bank of the liabilities of a parent or sister company might be a classic example of an undervalue transaction - if, say, the idea is simply to bleed the company to benefit its financially troubled parent or sister company. In relation to guarantees there is no authority on the test to apply to ascertain the value provided by the guarantor and provided by the bank. An interest-free loan might also constitute a transaction at an undervalue.

4.4 Preferences[69]

4.4.1 By way of overview, a preference is something which a company does, at a time when it is insolvent and it later goes into liquidation or administration, to put a creditor in a better position than he would have been if the company had instead just gone into liquidation. The attack is made by an administrator or a liquidator and, as for undervalues (above), the court has a range of options to restore the position.

Conditions for setting aside a 'preference'

4.4.2 The court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied:

(1) The company is in liquidation or administration and an application is made by the liquidator or administrator (s239 (1) and (2))

(2) The company gave the preference within a vulnerability period ending with the 'onset of insolvency' (s239(2))[70]. The vulnerability period is either six months or two years depending on the identity of the counterparty:

(a) in the case of a preference given to a connected person[71] (other than by reason of being its employee) the vulnerability period is two years; and (s240(1)(a));.

(b) In the case of a preference given to any other person, the vulnerability period is six months (s 240 (1)(b)).

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69 Section 239 IA 1986.
70 This concept is the same as for transaction at undervalue - see paragraph 4.3.2(2) above.
71 See answer to question 1 at paragraph 1.1.7, footnote 4 for an explanation of this concept.

(3) The company was unable to pay its debts as described above in connection with transactions at an undervalue save that there is no presumption of insolvency in the case of a connected person.[72]

What is a preference?

4.4.3 A company gives a preference to a person if:

(1) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities; and

(2) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done (s 239(4)).

Examples of preferences include the payment of a debt or giving of security to a particular creditor who would otherwise only have received partial payment on a winding-up.

4.4.4 In determining whether a creditor has been preferred, the critical test is whether what is done would have the effect of disturbing the statutory order of priorities in an insolvent liquidation. The phrase "going into insolvent liquidation" is not expressly defined in this provision but is presumed to mean a liquidation where creditors are not paid in full.

Defences

4.4.5 The court shall not make an order under this provision in respect of a preference given to any person unless the company which gave the preference was influenced in deciding to give it by a desire to have the effect of giving a preference to that person (s 240(5)). This is a question of fact - board minutes prepared when the relevant transaction was taken will be a starting point in this respect.

4.4.6 In *Re M C Bacon* (No. 1) at: 87 the court emphasised the distinction between a desire and an intention:

"Intention is objective, desire is subjective. A man can chose the lesser of two evils without desiring either … A man is not to be taken as desiring all the necessary consequences of his actions … It will still be possible to provide assistance to a company in financial difficulties provided that the company is actuated only by proper commercial considerations … a transaction will not be set aside as a voidable preference *unless the company positively wishes to improve the creditor's position in the event of its own insolvent liquidation*" (emphasis added).

Accordingly it was held that a decision by a company to give its bank a charge to secure existing borrowings (when the only alternative, if the bank

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[72] See paragraph 4.3.2(3) above

withdrew its support, was liquidation) was not voidable as a preference under this provision as the directors' desire was to obtain continued funding not to put the bank in a better position.

4.4.7 Where the beneficiary is connected with the company (otherwise than by reason of being its employee) at the time the preference is given, the company, unless the contrary is shown, is presumed to have been influenced in deciding to give a preference by the relevant desire.

4.4.8 There are the same protections for purchasers in good faith and for value as for transactions at an undervalue (see paragraph 4.3.7 above).

4.5 Transactions defrauding creditors[73]

Conditions

4.5.1 Where a transaction at an undervalue is entered into by a company for the purpose of putting assets beyond the reach of a person who is making or may at some time make a claim against the company or of otherwise prejudicing the interests of such person in relation to the claim he is making or may make, the court may make an order restoring and protecting the interests of the persons who are victims of the transaction.

4.5.2 It is not necessary that the company shall be in liquidation or administration, nor is there any statutory time limit. Essentially, this provision uses the same concept of 'undervalue' as for section 238 (discussed above) with the additional requirement that the company or person effecting the transaction does it for the purpose of putting assets beyond the reach of creditors but there is no requirement that the company be in an insolvency procedure.

Defences

4.5.3 There are protections for good faith purchasers for value without notice of the relevant circumstances (s425(2)).

4.6 Extortionate credit transactions[74]

Conditions

4.6.1 The court may set aside or vary a transaction for, or involving, the provision of credit to the company where the following conditions are satisfied:

(1) the company is or has been a party to the transaction;

(2) the company is in liquidation or administration (s 244(1) applying s 238(1)) and the administrator or liquidator brings an action;

(3) the transaction is or was 'extortionate'; and

[73] Section 423 IA 1986.
[74] Section 244 IA 1986.

(4) the transaction was entered into within the three years prior to the day on which the company entered administration or (as the case may be) the company went into liquidation.[75]

4.6.2 A transaction is regarded as extortionate if, having regard to the risk accepted by the person providing the credit:

(1) the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit, or

(2) it otherwise grossly contravenes ordinary principles of fair dealing (s 244(3)).

The concept is one of a party taking improper advantage of an imbalance in bargainers power so as to produce a result that is oppressive.

4.6.3 There is a rebuttable presumption that a transaction with respect to which an application is made under this provision is extortionate (s 244(3)).

Defences

4.6.4 There are no statutory defences (other than successfully to disprove the allegation).

4.7 Avoidance of floating charges for past value[76]

4.7.1 This provision, which is in addition to the law of preferences (above), is specifically aimed at preventing creditors obtaining floating charge security for past debts in certain circumstances. It is not designed to impugn security given for new credit.

Conditions for setting aside

4.7.2 A floating charge is void under this provision if the following conditions are satisfied:

(1) the company is in liquidation or administration; and

(2) the floating charge was created,

(a) in the case of a charge created in favour of a connected person within the period of two years ending with the onset of insolvency[77] (s 245(3)(a)); or

(b) in the case of a charge created in favour of any other person, within the period of 12 months ending with the "onset of insolvency" (s 245(3)(b)); or

(c) in the case of a charge created in favour of any person, between the

[75] That is, a winding-up order is made or resolution of members passed for voluntary winding-up.
[76] Section 245 IA 1986.
[77] See the explanation of that concept at paragraph 4.3.2(2) above.

presentation of an application for an administration order and the making of an order on that application (s 245(3)(c)); or

(d) in the case of a charge created in favour of any person, between the filing with the court of a copy of a notice of intention to appoint an administrator and the making of that appointment (s 245(3)(d)

(3) the charge was given otherwise than for new consideration (see below); and

(4) in the case of a charge given to a person not connected with the company, the company was then unable to pay its debts within the meaning of s123[78] or became unable to do so in consequence of the charge (s 245(4)).

4.7.3 Under section 245(2), no new consideration is given and the charge will be invalid except to the extent of the aggregate of:

(1) the value of so much of the consideration for its creation as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge;

(2) the value of so much of the consideration as consists of the discharge or reduction, at the same time as, or after, the creation of the charge, of any debt of the company; and

(3) the amount of interest (if any) payable on those sums which fall within paragraph (1) or (2) above in pursuance of any agreement under which money was paid, the goods or services supplied, or the debt reduced or discharged.

4.7.4 The new consideration must be for the charge and it must go to the company itself or in the reduction of the company's indebtedness. Where goods or services are provided rather than new money, it is the true value of the goods and services that counts, not the value that the parties may ascribe to them (s 245(6)).

Defences

4.7.5 There are no specific statutory defences available but, as discussed above, the charge will not be invalid to the extent that new value is provided.

4.7.6 It is worth considering two practical situations:

(a) Refinancing or rollover - in a two party situation this usually involves the discharge of an old debt and the creation of a new debt. Even where it cannot be said that the arrangement is a sham, a paper transaction such as this may not amount to new consideration.

(b) Overdraft turnover - a bank which operates an overdraft may benefit from the fact that fresh consideration may be provided at any time after the

[78] See the explanation of that concept at paragraph 4.3.2 above.

creation of the security. Drawings out of the account, even if replaced by payments into the account, represent new credit for these purposes[79] - and, over time, the whole balance in the account may be represented by these new withdrawals 'hardening' the security (i.e. rendering it invulnerable from attack under this head of challenge).

4.8 Breach by directors of general/common law duties

4.8.1 If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general common law duty to put the company's interests first. Where the counterparty has knowledge of this, there may be circumstances where there are proprietary or restitutionary rights to recover the property. These are rights under the general law and whilst not dependent upon insolvency as such, they are more likely to be examined and/or exercised after a formal insolvency event.[80]

4.9 Disclaimer of onerous property[81]

4.9.1 When the company is being wound up, the liquidator may, by giving the prescribed notice, disclaim any onerous property and may do so notwithstanding that he has taken possession of it, endeavoured to sell it, or otherwise exercised rights of ownership in respect of it.

4.9.2 Onerous property includes (a) any unprofitable contract; and (b) any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.

4.9.3 An example of onerous property would be a lease under which the company was the tenant and where the rent was greater than a market rent. Where the counterparty has a proprietary as opposed to a personal interest in the property, there can be no disclaimer: for example, where the company is selling land, contracts have been exchanged and the buyer tenders the purchase price, the buyer is likely to be able to obtain specific performance of such a contract.

4.9.4 There can be no disclaimer of an executed contract (one which has been wholly performed by one party but not the other) as opposed to an executory contract (where neither party has wholly performed its obligations).

4.9.5 The disclaimer does not affect rights and liabilities already accrued. It determines, as from its date, the future rights interests and liabilities of the company in or in respect of the property disclaimed. The disclaimer does not (except so far as necessary for the purpose of releasing the company from any liability) affect the rights or liabilities of any other person. Any person sustaining loss or damage as a consequence of the disclaimer is deemed to be a creditor of the company to the extent of such loss or damage and may prove as such.

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79 This is known as the rule in *Clayton's Case* (1816) 1 Mer 572.
80 See generally discussion of directors duties in answer to question 2
81 Section 178 IA 1986

4.10 Dispositions of the company's property made after the commencement of winding-up[82]

4.10.1 In a winding up by the court, any dispositions of the company's property, and any transfer of shares, or alteration in the status of the company's members, made after the commencement of the winding up is void. For example, a payment out of a company's bank account, whether in credit or debit, after the commencement of the winding up will constitute a void disposition in favour of the payee. A payment into a company's overdrawn bank account will also constitute a void disposition in favour of the bank.[83]

4.10.2 Commencement of the winding up backdates to the date of presentation of the petition (section 129 IA 1986) and the time of presentation of any petition for compulsory winding-up if an order is ultimately made. The voidness applies unless the court otherwise orders - so a company or a counterparty may seek a court validation order in respect of transactions in this period, when perhaps it is unclear whether the company will be able to pay off the petitioning creditor.

4.11 Failure to register a charge[84]

4.11.1 English law operates a system of registration of security created over certain property by English companies and by overseas companies which have an established place of business in England. Failure to register within 21 days of creation renders the charge void against an administrator or liquidator or a creditor (in practice a secured creditor). Whilst it is the company's duty to register the charge under section 399(1) CA 1985, any party interested in the charge is able to and, indeed, is well advised to effect the application itself. Any fees properly paid in doing this can be recovered from the company.

4.11.2 Section 396 defines the charges which have to be registered[85]:

(a) a charge for the purpose of securing any issue of debenture;

(b) a charge on uncalled share capital of the company;

(c) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale;

(d) a charge on land (wherever situated) or any interest in it, but not including a charge for any rent or other periodical sum issuing out of the land (the holding of debentures entitling the holder to a charge on land is not deemed to be an interest in land);

(e) a charge on book debts of the company (where a negotiable instrument has been given to secure the payment of any book debts of a company, the deposit of the instrument for the purpose of securing an advance to the company is not treated as a charge on those book debts);

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[82] Section 127 IA 1986
[83] *Re Tain Construction Ltd (Rose v AIB Group (UK) plc* [2003] All ER (D) 91.
[84] Section 395 Companies Act 1985
[85] Certain of the charges referred to in section 396 do not need to be registered – in essence, security over "financial collateral" (very broadly, cash, shares and tradeable bonds) if the security is taken within the context of a "security financial collateral arrangement" within the meaning given to that expression in the Financial Collateral Arrangements (No.2) Regulation 2003, in force 26 December 2003 (SI 2003/3226), which implements in the UK the Financial Collateral Directive (Directive 2002/47/EC).

(f) a floating charge on the company's undertaking or property;

(g) a charge on calls made but not paid;

(h) a charge on a ship or aircraft, or any share in a ship;

(i) a charge on goodwill, or on any intellectual property (i.e. any patent, trade mark, registered design, copyright or design right; or any licence under or in respect of any such right).

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Introduction

5.1.1 In the event of a company going into liquidation, administration or administrative receivership, the authority and powers of the directors are superseded following such an appointment and taken over by the liquidator, administrator or administrative receiver respectively. It is these office holders (and primarily a liquidator or administrator) who are required to review the action taken by the directors and others during the twilight period and where relevant bring proceedings to obtain compensation for the benefit of creditors in respect of any loss caused to the company. Consequently, in most cases it is the office holder only who is empowered to bring actions against directors and others where there has been a breach of either the legal or fiduciary duties owed to the company. There are a few exceptions to this rule in respect of certain transactions/offences for which action may be brought by creditors or others directly. These are detailed in the table below.

5.1.2 There are two main exceptions to this general rule. First, where criminal proceedings are brought against directors or others in respect of some form of criminal action, such proceedings must be brought by the Director of Public Prosecutions ("**DPP**") on behalf of the relevant government department or authority[86]. Secondly, only the Secretary of State ("**SST**"), or the Official Receiver (appointed where the company is being wound-up by the court) acting at his direction, may bring proceedings for disqualification under sections 6 ("unfitness" to be a director) and 8 (disqualification after investigation by the SST in a company's affairs) of the CDDA 1986.

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[86] Section 218 IA 1986.

5.2 Criminal Proceedings

5.2.1 The following acts are criminal offences in respect of which the DPP may bring an action against the directors and others involved. The office holder (such as a liquidator) of a company is under a duty to bring any such offences to the attention of the DPP. Those who may be liable in respect of the following offences in addition to the directors are listed in question 3 above.

Offences[87]

(a) Fraud in anticipation of winding-up - section 206

(b) Transactions in fraud of creditors - section 207

(c) Misconduct in course of winding-up - section 208

(d) Falsification of company's books - section 209

(e) Material omission from statement relating to company affairs - section 210

(f) False representations to creditors - section 211

(g) Restriction on re-use of company name - section 216

(h) Fraudulent trading - section 458 Companies Act 1985

5.3 Civil Proceedings

5.3.1 In relation to civil proceedings, the ability to bring actions against directors and others is primarily held by the relevant office-holder. However, in respect of certain actions which have caused loss to the company and its creditors, the law allows a wider range of persons to bring action to recover funds for the benefit of the company's creditors. Where an action for a contribution to the company's assets is successful, even if the person bringing the action is not the office-holder, any recoveries made will be for the benefit of all creditors of the company and will be distributed amongst the creditors in accordance with the normal rules relating to priority.

5.3.2 The table below sets out those people who may bring an action against the directors and others in connection with certain transactions which the company has entered into or for disqualification proceedings.

[87] All section references are to the Insolvency Act 1986 unless specified otherwise.

Activity/transaction	Person able to bring proceedings
Misfeasance	Liquidator, Official Receiver, a creditor or, with leave of the court, a contributory[88] and, if the misfeasance action is pursuant to paragraph 75 of Schedule B1 to the IA 1986, the administrator of the company
Fraudulent trading	Liquidator only[89]
Wrongful trading	Liquidator only
Personal liability for unlawful re-use of company name	DPP[90]
Transaction at undervalue	Liquidator or administrator only
Preference	Liquidator or administrator only
Extortionate credit transactions	Liquidator or administrator only
Transactions defrauding creditors	Liquidator, administrator, the Official Receiver and, with leave of the court, a "victim"[91]
Disqualification as a director (1)	For offences under sections 2-5 CDDA 1986, SST, Official Receiver, liquidator, any past or present member or creditor of the company
Disqualification as a director (2)	For offences under sections 6 and 8 CDDA, SST and Official Receiver only

88 A contributory is defined in section 79 IA 1986 to include every person who is liable to contribute to the assets of a company in liquidation and will include all those referred to in question 3 who become liable as a result of their involvement in the company. The leave of the court is not required for a contributory to bring a misfeasance action under paragraph 75 of Schedule B1 to the IA 1986, Where proceedings against a person are ongoing, such a person (the "alleged contributory") will be treated as a contributory with the same rights to bring an action.

89 An action brought under this provision is for a contribution towards the assets of the company. Criminal proceedings will be brought under section 458 Companies Act 1985.

90 Liability is automatic if the criminal offence is proved. No further or specific application need be made by or on behalf of the company.

91 A "victim" is defined as being a person who is, or is capable of being, prejudiced by the relevant transaction.

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

Offence	Remedy Available
Wrongful Trading	The director may be ordered to make such contribution to the company's assets as the court thinks fit. However jurisdiction under section 214 is primarily compensatory.[92] Where the court makes a contribution declaration it may make further directions to give effect to it as set out below in connection with section 213 IA 1986. Where the Court makes a declaration under section 214 that an individual is liable to make contribution to a company's assets, then whether or not an application has been made for his disqualification, the court may make an order that he be disqualified from acting as a company director for a period of up to 15 years.
Fraudulent Trading[93]	If tried by a jury the penalty is up to seven years imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Fraudulent Trading[94]	The director may be ordered to make such contribution to the company's assets as the court thinks fit. The Court may not include a punitive element in its order. Where the court makes a contribution declaration it may make further directions to give effect to the declaration such as, for example, imposing a charge on any debt or obligation due from the company to him or the deferral of debts due from the company to him. Where the Court makes a declaration under section 213 that an individual is liable to make contribution to a company's assets, then whether or not an application has been made for his disqualification, the court may make an order that he be disqualified from acting as a company director for a period of up to 15 years.

92 It is not entirely clear whether the court can include a punitive as well as a compensatory element in its order. In the light of *Morphitis v Bernasconi* [2003] All ER (D) 33 which held that an order for fraudulent trading may not include a punitive element, it perhaps now doubtful that this may form part of a wrongful trading order.

93 Under Section 458 Companies Act 1985 - criminal liability.

94 Under Section 213 IA 1986 - civil liability requiring a director to contribute to the assets of the company for loss caused.

Offence	Remedy Available
Fraud in anticipation of a winding up	If prosecuted on indictment and tried by a jury the penalty is up to seven years' imprisonment and/or a fine and, on summary conviction (non-jury trial), a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Transactions in fraud of creditors	If tried by a jury the penalty is up to two years' imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Misconduct in winding up	If tried by a jury the penalty is up to seven years' imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Falsification of Company Books	If tried by a jury the penalty is up to seven years' imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Material omissions from statement relating to the company's affairs	If tried by a jury the penalty is up to seven years' imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
False representations to creditors	If tried by a jury the penalty is up to seven years' imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Misfeasance	This section provides a mechanism for summary trial and does not create any new category of liability. The Court may order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the Court sees fit or to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the Court sees fit.
Re-using a prohibited company name	*Criminal liability* If tried by jury the court can order imprisonment for up to 2 years and/or a fine. If tried summarily the court can order imprisonment for up to six months and/or a fine up to the statutory maximum (£5,000). *Civil liability* The director may be held personally liable for the debts of the company incurred whilst trading under the restricted name.

Offence	Remedy Available
Destroying, mutilating company documents including making an omission in a document[95]	These offences can lead to imprisonment for six months and/or a fine of £1,000 for a summary conviction and imprisonment for seven years and/or a fine for a conviction on indictment.
Fiduciary Duties	The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.
Duties of skill and care	The director may be ordered to compensate the company for all loss and damage caused by breach of his fiduciary duty.
Conduct rendering a director unfit to be a director[96]	The court may order disqualification for a period of between 2 and 15 years. There is no financial penalty.
Transactions at an undervalue and preferences	The court may make such order as it thinks fit in order to restore the position to that which would have existed if the company had not entered into the impugned transaction. It may, for example, order: (a) that any property transferred as part of the impugned transaction be re-vested in the company; (b) that any property which represents the application of either the proceeds of sale of the property or money wrongfully transferred be vested in the company; (c) the release or discharge of any security given by the company; (d) require any person to pay such sums as represent the value of any benefits received by him from the company in breach of sections 238 or 239 IA 1986; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or in part) under the transaction, or by giving of the preference, to be under such new or revived obligations to that person as the court thinks appropriate; (f) that security be provided for the discharge of any obligation imposed by or arising under the order; or

[95] Section 450 Companies Act 1985
[96] Section 6 CDDA 1986

Offence	Remedy Available
	(g) provide for the extent to which any person whose property is vested by the order in the company, or on whom obligations are imposed, is to be able to prove in the winding up of the company for debts or other liabilities which arose from, or were released or discharged under or by, the transaction or the giving of the preference. An order under these provisions cannot prejudice any interest acquired from a person other than the company which was acquired in good faith and for value. It cannot prejudice any interest deriving from such an interest. It must not require a person who received a benefit from the impugned transaction in good faith and for fair value to make payment except where that person was a party to the transaction with the company or was a creditor of the company at the time of the transaction.
Transactions defrauding creditors[97]	The court may: (a) require that any property transferred as part of the transaction be vested in any person, either absolutely or for the benefit of all the persons on whose behalf the application for the order is treated as made; (b) require any property to be vested in any person's hands which represents either the proceeds of sale of property or of money so transferred; (c) release or discharge (in whole or part) any security given by the debtor; (d) require any person to pay to any other person in respect of benefits received from the debtor such sums as the court may direct; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or part) under the transaction to be under such new or revived obligations as the court thinks appropriate; (f) provide for security to be provided for the discharge of any obligation imposed by or arising under the order for such an obligation to be charged on any property and for such security or charge to have the same priority as a security or charge released or discharged (in whole or in part) under the transaction.

[97] Section 423 IA 1986. The requirements for liability to arise under this provision are explained in question 5 above. Liability under section 423 is civil.

Offence	Remedy Available
	Any order made must not prejudice any interest in property acquired from a person other than the debtor which was acquired in good faith for value and without notice of the relevant circumstances. The court shall not require any person who derived a benefit from the impugned transaction in good faith without notice of the relevant circumstances, to pay any sum unless he was a party to the transaction.
Extortionate Credit Transactions[98]	The impugned transaction may be set aside or the court may make an order to vary the transaction on such terms as it sees fit. It may, for example, make an order: (a) setting aside the whole or part of any obligation created by the transaction; (b) varying the terms of the transaction or the terms on which any security for the purposes of the transaction is to be held; (c) requiring any person who is or was a party to the transaction to pay to the office-holder any sums paid to that person by virtue of the transaction, by the company; (d) requiring any person to surrender to the office-holder any property held by him as security for the purposes of the transaction; (e) directing accounts to be taken between any persons.
Avoidance of a floating charge[99]	The Court can declare that the floating charge is invalid in whole or in part.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European

99 Section 245 IA 1986. See explanation of these provisions in answer to question 5. Liability is civil.

jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Obligation to co-operate with investigation into company's affairs

General duty to co-operate

7.1.1 Section 235 IA 1986 applies in the case of a company where:

(a) the company enters into administration; or

(b) an administrative receiver is appointed; or

(c) the company goes into liquidation; or

(d) a provisional liquidator is appointed[100].

7.1.2 Under section 235, there is a duty imposed on certain people to co-operate with any administrator, administrative receiver, liquidator, or provisional liquidator of a company or the 'Official Receiver'[101]. The duty is:

(a) to give to the office-holders mentioned above such information concerning the company and its promotion, formation, business dealings, affairs or property as the office-holder may at any time after the effective date reasonably require; and

(b) to attend on the office-holder at such times as the latter may reasonably require.

7.1.3 The "effective date" is whichever is applicable of the following dates:

(a) the date on which the administration order was made; or

(b) the date on which the notice of appointment of an administrator was filed in court (if appointed out of court); or

(c) the date on which the administrative receiver was appointed or, if he was appointed in succession to another administrative receiver, the date on which the first of his predecessors was appointed; or

(d) the date on which the provisional liquidator was appointed; or

(e) the date on which the company went into liquidation (i.e. the date it passed a resolution for voluntary winding up or the court made an order for its winding up).

7.1.4 The duty is imposed on the following people:

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[100] Such a person is appointed by the court at any time after the presentation of a winding-up petition and before the making of a winding-up order: section 135 IA 1986.

[101] The Official Receiver is a civil servant from The Insolvency Service, an agency operating under the aegis of the Department of Trade and Industry. He is often appointed liquidator on a winding-up order being made, although where there are assets in the liquidation a creditors meeting will be likely to appoint a private accountant liquidator.

(a) those who are or have at any time been officers of the company - this will include a director, manager or secretary of a company;

(b) those who have taken part in the formation of the company at any time within one year before the effective date;

(c) those who are in the employment of the company, or have been in its employment (including employment under a contract for services - which includes those who have provided professional services to the company, for example, accountants) within that year, and are in the office-holder's opinion capable of giving information which he requires;

(d) those who are, or have within that year been, officers of, or in the employment (including employment under a contract for services) of, another company which is, or within that year was, an officer of the company in question; and

(e) in the case of a company being wound up by the court, any person who has acted as administrator, administrative receiver or liquidator of the company.

Sanction

7.1.5 If a person without reasonable excuse fails to comply with any obligation imposed by section 235 IA 1986, he is liable to a fine and, for continued contravention, to a daily default fine.

7.2 Obligation to assist with getting in the company's property[102]

7.2.1 Section 234 IA 1986 applies in the case of a company where:

(a) the company enters into administration; or

(b) an administrative receiver is appointed; or

(c) the company goes into liquidation; or

(d) a provisional liquidator is appointed.

7.2.2 Where any person has in his possession or control any property, books, papers or records to which the company appears to be entitled, the court may require that person forthwith (or within such period as the court may direct) to pay, deliver, convey, surrender or transfer the property, books, papers or records to the office-holder.[103]

Sanction

7.2.3 There are no specific sanctions for breach of this section; but the court would use its inherent powers to enforce.

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[102] Section 234 IA 1986

[103] That is the administrator, administrative receiver, liquidator or provisional liquidator.

7.3 Obligation to provide information[104]

7.3.1 Section 236 IA 1986 applies in the same circumstances as does section 235 and "office-holder" has the same definition as in that section. Under section 236, the court may, on the application of the office-holder, summon to appear before it:

(a) any officer of the company;

(b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or

(c) any person whom the court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.

This section therefore has a potentially very wide application.

7.3.2 Such person may be required (a) to submit an affidavit to the court containing an account of his dealings with the company; or (b) to produce any books, papers or other records in his possession or under his control relating to the company or its promotion, formation, business, dealings, affairs or property.

Sanctions

7.3.3 If a person does not appear before the court when summoned, or if there are reasonable grounds to believe that a person is intending to avoid his appearance, the court may issue a warrant for the arrest of the person and the seizure of any relevant property. The courts' enforcement powers with respect to section 236 also include powers (under section 237) to:

(a) order any person who, as it appears to the court, on consideration of any evidence obtained under sections 236 or 237, has in his possession any property of the company, to deliver the whole or any part of the property to the officer-holder at such time, in such manner and on such terms as the court thinks fit; and

(b) order any person who, as it appears to the court, on consideration of any evidence so obtained, is indebted to the company, to pay to the office-holder, at such time and in such manner as the court may direct, the whole or any part of the amount due, whether in full discharge of the debt or otherwise, as the court thinks fit.

There are also powers to examine persons either in the UK or abroad.

7.4 Company's statement of affairs[105]

7.4.1 Where the court has made a winding-up order or appointed a provisional liquidator, the official receiver may require certain persons to make out and submit to him a statement of the affairs of the company. The persons who may be required to provide such a statement are as follows:

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104 Section 236 IA 1986
105 Section 131 IA 1986

(a) those who are or have been officers of the company;

(b) those who have taken part in the formation of the company at any time within one year before the relevant date;

(c) those who are in the company's employment, or have been in its employment within that year, and are in the official receiver's opinion capable of giving the information required; or

(d) those who are or have been within that year officers of, or in the employment of, a company which is, or within that year was, an officer of the company.

Sanction

7.4.2 Under section 210 IA 1986, past or present officers of the company may commit an offence if they make material omissions from the statement of affairs.

7.5 Public examination of officers[106]

7.5.1 Where a company is being wound up by the court, the Official Receiver may at any time before the dissolution of the company apply to the court for the public examination of any person who (a) is or has been an officer of the company; or (b) has acted as a liquidator or administrator of the company or as receiver or manager of its property; or (c) not being such a person, is or has been concerned, or has taken part in the promotion, formation or management of the company.

Sanction

Under section 134 IA 1986, if a person fails to attend his public examination without reasonable excuse he is guilty of contempt of court and liable to be punished accordingly. A warrant for his arrest and the seizure of any books, papers, records, money or goods in that person's possession may also be issued if he fails to attend or if there are reasonable grounds for believing that he has absconded or is about to do so.

7.6 Obligation to provide accounts[107]

7.6.1 In a creditors' voluntary liquidation ("**CVL**")[108] a liquidator, or, in a compulsory liquidation, the official receiver, may request any of the people who may be required to co-operate with an office-holder under section 235(3) to furnish him with the accounts of the company of such nature, as at such date, and for such period, as he may specify.

7.7 Enforcement – Sanction for failing to discover to the liquidator the company's property and papers when it is being wound up[109]

[106] Section 133 IA 1986
[107] Rules 4.39 and 4.40, IR 1986
[108] A CVL is a winding-up effected by a resolution of the shareholders of the company but in respect of which the control is primarily in the hands of the creditors rather than the court.
[109] Section 208 IA 1986

7.7.1 Section 208 IA 1986 imposes a penalty (imprisonment or a fine) on any person who, being a past or present officer of the company which is being wound up, amongst other things:

(a) fails to discover to the liquidator all the company's property and how any of it may have been disposed of (if other than in the ordinary course of business); or

(b) fails to deliver up to the liquidator all property or books and papers belonging to the company which are in his custody or control; or

(c) fails to inform the liquidator of any false debt which he believes has been proved by any person in the winding up; or

(d) after the commencement of the winding-up prevents production of books and papers relating to the company's property or affairs.

7.8 Human rights

7.8.1 On 2nd October, 2000, the Human Rights Act 1998 (the "**HRA**") came into force. The HRA incorporates into domestic law the rights and freedoms set out in the Convention for the Protection of Human Rights and Fundamental Freedoms (Treaty of Rome, 4th November, 1950) (the "**Convention**") as well as the 1st and 6th Protocols (which are defined together as the "**Convention Rights**").

7.8.2 The directors and others identified in question 3 will have Convention Rights. This is the case whether they are individuals or companies. In an insolvency context, a director or other person with Convention Rights under the HRA will be able to:

(a) require that a particular provision of insolvency law is construed in accordance with those rights or otherwise declared incompatible; or

(b) claim that the insolvency practitioner is a public authority and is acting unlawfully in breach of that person's Convention Rights.

7.8.3 The application of the HRA will also have the following effects:-

(a) Legislation - Primary and subordinate legislation will be read in a way that is compatible with the Convention Rights. If this is not possible, the court may make a declaration of incompatibility. In the case of subordinate legislation (for example the Insolvency Rules 1986) the court may give relief against any incompatibility provided that this is not inconsistent with the primary legislation (for example the Insolvency Act 1986).

(b) Public authorities - It will be unlawful for public authorities to act in a way which is incompatible with a Convention Right. A victim may bring proceedings for judicial review or damages. "Public authority" is not defined under the HRA, but it includes persons whose functions are of a public nature. If the nature of the act is private, then the performer of the act is not a public authority. As officers of the court, the Official Receiver, administrators, compulsory liquidators, provisional liquidators and court appointed receivers are all "public authorities" when carrying out functions of a public nature. Voluntary liquidators and administrative receivers are not officers of the court but have public functions so are also likely to fall within the definition.

7.8.4 However, it should be recognised that the Convention Rights are not absolute and may well be limited by authorised interference by the state where such interference is (a) justified by a limited aim and/or (b) proportionate to the need in hand.

7.8.5 In the context of insolvency, and the duties of co-operation discussed above, certain Convention Rights may be particularly relevant. These include:

(a) Article 6 - the right to a fair trial;

(b) Article 4 - prohibition of slavery and forced labour

(c) Article 8 - right to respect for private and family life;

(d) Protocol 1, Article 1 - right to the peaceful enjoyment of possessions.

7.9 Article 6 – Right to a fair trial

7.9.1 Article 6(1) provides that:

"In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly but the press and public may be excluded from all or part of the trial in the interests of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice."

These provisions apply in respect of both civil and criminal proceedings.

7.9.2 In criminal proceedings, the use of compelled statements makes those proceedings unfair.[110] Accordingly, section 433 IA 1986 has been amended[111]and now provides that any statement of affairs or other statement made in pursuance of a requirement imposed by the IA 1986 shall be inadmissible in criminal proceedings. In civil proceedings, however, the use of compelled evidence does not *per se* mean that a hearing is unfair.[112] It would be a matter for the defendant to raise, as he thought fit, at the civil proceedings.

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110 *Saunders v UK* (1997) 23 EHRR 313 [1998] 1 BCLC 362; e*x parte McCormick* [1998] BCC 379. Followed in I.J.L, G.M.R. and A.K.P. v United Kingdom (Application Nos 29522/95, 30056/96 and 3057/96) [2000] BCC 380 and Kansal v The United Kingdom (European Court of Human Rights, 27 April 2004)

111 Amended by the Youth Justice and Criminal Evidence Act 1999 with effect from 14 April 2000.

112 *Re Westminster Pty Management Ltd, Official Receiver v Stern* (Court of Appeal, 2nd February, 2000). In *Shierson v Rastogi* [2002] All ER (D) 124, Gibson L.J. commented in relation to impending civil proceedings against the directors that "what use may be made at the trial of answers given in [a s 236] examination will be subject to the control of the trial judge. It is not inconceivable that a challenge on Article 6 grounds to the use of particular answers may be mounted then.".

7.9.3 There is some debate whether directors' disqualification proceedings (under CDDA 1986) are criminal or civil in nature. The case-law suggests that such proceedings are regulatory and not criminal, although they are capable of being described as penal.[113] Thus the Court of Appeal has held that the use of statements obtained by an insolvency practitioner under section 235 IA 1986 in disqualification proceedings does not necessarily involve a breach of Article 6(1). However, statements taken under section 236 of the IA 1986 *may* be treated differently[114]. The public examination of officers of a company being wound up by the court (under section 133 IA 1986 – see above) is not contrary to Article 6.[115]

7.9.4 It has been suggested that, whilst the original application for an examination under section 236 IA 1986 will be governed by Article 6, the examination itself will not because this is not a hearing for the determination of substantive rights.[116]

7.10 Article 4 - Prohibition of slavery and forced labour

7.10.1 Under Article 4(2), no one shall be required to perform forced or compulsory labour. There is an argument that work that a director (or other person) may be required to do in complying with the obligations to co-operate with an investigation into the company's affairs following its insolvency may be forced labour contrary to Article 4. However, forced or compulsory labour does not include any work or service which forms part of normal civic obligations (Article 4(3)(d)). Therefore, any such argument is, in most cases, likely to fail, as the duties of co-operation are almost certainly part of a director's normal civic obligations.

7.11 Article 8 – Right to respect for private and family life, home and correspondence

7.11.1 Article 8 provides as follows:

(1) Everyone has the right to respect for his private and family life, his home and his correspondence.

(2) There shall be no interference by a public authority with the exercise of this right except such as is in accordance with the law and is necessary in a democratic society in the interests of national security, public safety or the economic well-being of the country, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others."

7.11.2 This article may give grounds for challenge where the investigation intrudes into the director's personal correspondence[117]. The exception in Article 8(2) means that the interests of the creditors are likely to prevail over most arguments that any examination or investigation is in breach of Article 8.[118]

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113 See *Re Westminster Pty Management Ltd, Official Receiver v Stern* (ibid) and *D.C., H.S. & A.D. v UK*, (ECHR, 14th September, 1999). There is, however, much debate over this issue, and strong argument that proceedings under CDDA 1986 should be treated as being criminal for the purposes of Article 6.

114 *Re Westminster Pty Management Ltd, Official Receiver v Stern* (ibid).

115 *Slinn v UK*, 26th June, 1996.

116 See *Fayed v UK* (1994) 18 EHRR 393.

117 Cf *Haig v Aitken* [2000] 2 All ER 80, where, in the context of bankruptcy, the Article 8 right confirmed the judge's view that private correspondence was not to property within the bankrupt estate.

118 A fortiori, in the context of bankruptcy, the compulsory psychiatric examination of a bankrupt was allowed where that was in the interests of creditors: *Meeder v Netherlands,* 9 EHRR 546 (1986).

7.12 First Protocol, Article 1 – Protection of property

7.12.1 This provision provides that:

> "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law."
>
> "The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

7.12.2 It is quite likely that any challenge, under Article 1 of Protocol 1, to the directors' or others' liability to contribute to the assets of the company (for example under one of the heads listed in question 2) is likely to fail because there is a general interest in such contribution (for example to protect creditors and to ensure the good management of companies).
There is still the requirement of proportionality.

7.13 Human Rights law in practice

7.13.1 Undoubtedly the HRA does have practical relevance and cannot be ignored. Cases based on a breach of the HRA have been reported regularly in the insolvency arena since it came into force[119] and nor are these cases restricted to those matters dealt with in this question. There have, for example, been a number of claims based on an infringement of the right to a fair trial within a reasonable time (Article 6) in the context of director disqualification proceedings which have taken an inordinate amount of time to reach court. Its ambit is therefore wide reaching and full consideration of its implications is beyond the scope of this work.

7.13.2 Each case has been dealt with on its facts. But the general sense is that the courts have been robust in resisting spurious human rights arguments following the introduction of the HRA [120] and have sensibly adopted the "proportionate" response necessary in the context of insolvency legislation designed to administer the affairs of the insolvent and to protect creditors and the public generally[121].

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119 And the European Court of Human Rights has recently held that the HRA can apply retrospectively to cases which predate the HRA and the amended section 433 IA 1986: *Kansal v The United Kingdom*, 27 April 2004

120 *Walker v Daniels* [2000] 1 WLR 1382

121 *R v Kearns* [2002] All ER (D) 363

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

Limitation Period for Criminal Proceedings

8.1.1 No limitation periods apply to the offences attracting criminal liability which have been identified in the answers to questions 2 and 6.

Limitation Period for Civil Actions

8.1.2 In relation to any liabilities created by sections of the Insolvency Act 1986 the limitation period is 6 years from the date on which the cause of action accrued[122].

8.1.3 In relation to breaches of the director's fiduciary duties the limitation period is generally 6 years from the date on which the cause of action accrued[123]. No limitation period will apply if there has been a fraudulent breach of trust or to recover trust property or the proceeds of trust property which have been retained by the director or received by him and converted to his own use[124]. Case law has interpreted this widely so as to include the use of trust proceeds by a director for the benefit of a company he indirectly controls.[125]

8.1.4 In relation to breaches of the director's common law duties the limitation period is also 6 years from the date on which the cause of action accrued [126].

8.1.5 The limitation period applying to disqualification applications pursued under section 6 of the CDDA 1986 is 2 years from the date on which the company went into either insolvent liquidation, administration or administrative receivership. The court does enjoy a discretion, however, to extend this period which may be exercised in circumstances where, for example, the director has contributed to the delay in bringing proceedings, the charges laid against the director are particularly serious and there is a public interest in ensuring that they are pursued and where it is still possible for the director to receive a fair trial.

[122] Section 9 of the Limitation Act, 1980

[123] Section 21(3) of the Limitation Act 1980

[124] Section 21(1) of the Limitation Act 1980. *Belmont Finance v Williams (No. 2)* [1980] 1 AER 393

[125] Re Pantone 485 Ltd [2002] 1 B.C.L.C. 266

[126] Section 2 of the Limitation Act 1980 in the case of liability founded in tort. This time limit may be extended under section 14A of the 1980 Act in the event that the facts relevant to the cause of action were not known at the date on which it accrued. The extension allowed under this section is a further 3 year period from the date on which the claimant had both the knowledge required to bring the claim and the right to do so. This is subject to a long stop under section 14 of the 1980 Act which provides that no action shall be brought in respect of a negligence claim more than 15 years after the date on which the act of negligence relied upon occurred.

8.2 Appeals

8.2.1 The Court of first instance may be invited to review, rescind or vary any order made by it in the exercise of its insolvency jurisdiction[127] .

8.2.2 Appeal may take the form of an appeal from the decision of the court of first instance or from its refusal to review, rescind or vary its order. These appeals are based on an error made in the findings of fact or an error of law or a wrongful exercise of discretion. The appellate court will overturn an exercise of discretion by the court of first instance only if it is satisfied that no judge, properly instructed as to the law with regard to the relevant facts, could have reached the conclusion that was reached in the court below.

8.2.3 Hearings take place at first instance before either a County Court Judge, a Registrar of the High Court or a Judge of the High Court depending upon the complexity of the case and the value of the amount in issue. An appeal from the decision of the County Court Judge and the Registrar lies to the Judge of the High Court without permission. The permission of either the Judge of the High Court or of the Court of Appeal is required for an appeal from the decision of the Judge of the High Court sitting as a court of first instance to the Court of Appeal. If the Judge of the High Court is hearing the matter on appeal from the County Court or a Registrar of the High Court, permission from the Court of Appeal is required for a further appeal[128].

8.2.4 These provisions apply to civil proceedings brought under the Court's insolvency jurisdiction. Where criminal offences are concerned, the procedure of the criminal courts applies. Instead of the County Court and the High Court, the process evolves in:

(1) the Magistrates' Court dealing with less serious offences; and

(2) the Crown Court dealing with more serious offences and appeals from the Magistrates' Courts.

The Criminal Division of the Court of Appeal hears appeals from the Crown Court.

8.2.5 Where the civil proceedings are based on breach of the director's fiduciary or common law duties (which are not insolvency proceedings) similar appeal principles apply although permission is required where the appeal is from a decision of a judge in a county court.[129].

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[127] Rule 7.47(1) of the IR 1986
[128] Practice Direction [2000] BCC 927
[129] CPR Part 52.3

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Introduction

9.1.1 As noted in question 5 above, subject to criminal proceedings, the ability to enforce the rights and duties of directors will usually be undertaken by an "office holder" appointed pursuant to either a winding-up order or appointed upon the company going into administration. In particular, the tables set out in question 5 above specify who may bring actions against a director. Consequently, the ability to bring actions against directors of foreign companies will, first and foremost, depend on the jurisdiction of the English courts to wind-up a foreign company or alternatively to place a foreign company in administration.

9.1.2 On 31 May 2002, the EC Regulation on Insolvency Proceedings[130] (the "Regulation") came into force across the European Union (with the exception of Denmark)[131]. It determines in which Member State(s) insolvency proceedings for a company can be commenced and hence whether there is jurisdiction in England to wind-up or place a foreign company into administration. The Regulation applies only to companies with their "centre of main interests" (see below) in the European Union.

9.1.3 It is necessary, therefore, to consider (i) foreign companies to which the Regulation applies (EU companies) and (ii) other foreign (non-EU) companies.

9.1.4 The Regulation provides for two types of insolvency proceedings:

(a) "main insolvency proceedings" which can only be opened in the Member State where the company has its "centre of main interests" ('CoMI'). There is no comprehensive definition of 'CoMI' in the Regulation but there is a rebuttable presumption that it is the place of its registered office. Recital (13) to the Regulation also states that CoMI "should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." Main insolvency proceedings have universal scope, encompassing all the debtor's assets on a Community-wide basis and affecting all creditors, wherever located;

(b) "secondary proceedings" which may be opened in any Member State where the company possesses an "establishment". "Establishment" is defined in the Regulation as "any place of operations where the debtor

130 Council Regulation (EC) No 1346/2000 of 29 May 2000

131 The Regulation now also applies to the countries that acceded to the European Union on 1 May 2004.

carries out a non-transitory economic activity with human means or goods". This is likely to include a branch office of a foreign company or an established place of business, but the mere presence of assets, such as a bank account, will not constitute an establishment. Secondary proceedings are limited in scope to assets located in the Member State where they are opened. Liquidation, but not administration, can be opened as secondary proceedings in England.

9.1.5 Accordingly, if a company has its CoMI or establishment in England, it may (notwithstanding that the company was incorporated elsewhere) become subject to liquidation and administration proceedings in England. The IA 1986 now expressly envisages that administration and liquidation proceedings may be opened in respect of any company to which the Regulation applies.

9.1.6 Subject to certain exceptions, the law applicable to main insolvency proceedings is the law of the Member State in which the proceedings are opened[132] . Likewise, the law applicable to secondary proceedings is that of the Member State in which the secondary proceedings are opened[133].

9.2 Foreign (EU) company with CoMI in England

9.2.1 Article 4 of the Regulation provides that where English insolvency proceedings are opened as main proceedings, English insolvency law will apply to the insolvency proceedings and their effects and will, amongst other matters, determine the powers of the liquidator[134] and the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors. As noted in paragraph 5.1.1 above, it is the office holders (i.e. primarily the liquidator and administrator) who are required to review the actions of directors (and others) in the twilight period and to bring proceedings, as appropriate. Hence, the powers of a liquidator or administrator outlined above in question 5 will apply equally in respect of directors of a foreign (EU) company which is subject to the Regulation.[135]

9.2.2 Moreover, Article 18(1) of the Regulation further provides that the liquidator or administrator appointed in main proceedings may exercise all the powers conferred on him by English law in any other Member State (so long as no other insolvency proceedings have been opened in that Member State nor any preservation measure to the contrary has been taken there further to a request for the opening of insolvency proceedings in that State) and may, in particular, remove assets from other Member States in which they are situate. In exercising his powers, the office-holder must comply with the local laws of the Member State.

132 Article 4 of the Regulation

133 Article 4 and 28 of the Regulation

134 "Liquidator" under the Regulation means any person or body whose function is to administer or liquidate assets of the debtor or to supervise the administration of the debtor's affairs and includes both a liquidator and an administrator of a company.

135 If English insolvency proceedings are opened as main proceedings in respect of a foreign corporation, the Regulation provides that English law will apply to the conduct of the insolvency proceedings. An action for wrongful or fraudulent trading, which is an insolvency-related action and which can only be brought in the context of insolvency proceedings, would therefore be caught by the terms of the Regulation and English law would apply. But English law will not determine, for example, whether there has been a breach of the directors' fiduciary duties since this is not a matter of insolvency law but, rather, local corporate law. Equally, director disqualification proceedings under the CDDA 1986 may possibly not apply to directors of an EU foreign corporation either. Whilst such proceedings are often brought in the context of insolvency proceedings, they are not insolvency proceedings per se and may accordingly fall outside of the jurisdictional ambit of the Regulation. (Contrast this, perhaps oddly, with the position of a foreign non-EU company to which the Regulation does not apply – paragraphs 9.4.6 and 9.4.7 below.) As yet, however, there have been no reported cases on this aspect of the Regulation and so exactly how this is to work remains open to debate.

9.2.3 In relation to the matters considered in Question 4 above, the vulnerability of any transaction at an undervalue or preference entered into during the twilight period will be subject to the application of Article 13 of the Regulation.

9.3 Foreign (EU) company with an establishment in England, but not its CoMI

9.3.1 Where a foreign EU company has an establishment but no CoMI in England, secondary (liquidation, but not administration) proceedings can be opened in England but the effect of those proceedings will be restricted to the assets located in England[136]. English law will apply.

9.3.2 The powers of the liquidator outlined above will apply to all assets situate in England. Additionally, a liquidator in secondary proceedings has a specific power to repatriate, through the courts or out of court, any assets which have been removed from England to another Member State after proceedings have been opened and to bring any action to set aside which is in the interests of the creditors[137].

9.3.3 The point, which has not yet been considered by the English courts, is whether proceedings for wrongful or fraudulent trading may be brought by a liquidator appointed in secondary proceedings in England against the directors of a foreign corporation. Secondary proceedings are restricted to the company's assets in the jurisdiction in which the secondary proceedings have been opened and, on a strict interpretation, wrongful/fraudulent trading proceedings are not an asset of the company. One view, therefore, is that a liquidator in secondary proceedings cannot bring an action for wrongful or fraudulent trading. A, perhaps, more practical and pragmatic interpretation of the Regulation would be that a liquidator can bring such proceedings (even if the directors are or may become subject to a similar proceedings elsewhere in the main proceedings[138]) but that the proceedings must be restricted to assets and trading relating to or situate in England. The office-holder in the main proceedings and the liquidator in any secondary proceedings would, in any event, be required under the Regulation to co-operate with each other and one would therefore expect a coordinated approach to such matters to be adopted.

9.3.4 The comments in footnote 135 with regard to the CDDA 1996 director disqualification proceedings apply equally to secondary proceedings opened in respect of a foreign corporation.

9.3.5 In relation to the matters considered in Question 4 above, the vulnerability of any transaction at an undervalue or preference entered into during the twilight period will be subject to the application of Article 13 of the Regulation.

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136 Article 3(2) and (3) of the Regulation.

137 Article 18(2) of the Regulation.

138 If proceedings for wrongful trading and its equivalent in another jurisdiction were brought against the directors in both main and secondary proceedings, the directors should not have to contribute more than the total loss caused by their wrongful trading. A judgment handed down by a court with jurisdiction in the main or the secondary proceedings and which concerns the course of those insolvency proceedings must be recognised in all other Member States without further formality; consequently any amount which the directors are ordered to pay under the first set of proceedings should be taken into account when quantifying any contribution they are required to make under any order made in another jurisdiction.

9.4 Foreign (non-EU) companies to which the Regulation does not apply

9.4.1 A foreign company (to which the Regulation does not apply) may be wound up, in certain circumstances, as an "unregistered" company[139]. In general, all the provisions of the IA 1986 will apply equally on the winding-up of an "unregistered" company[140].

9.4.2 The IA 1986 provides no specific criteria for determining when it is appropriate for the English courts to assume jurisdiction and wind-up an unregistered company. Instead, the courts have developed a general test consisting of three "core" requirements. These can be summarised as follows:

(a) there must be a sufficient connection with England and Wales which may, but does not necessarily have to, consist of assets within the jurisdiction of the English court;

(b) there must be a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order; and

(c) one or more persons interested in the distribution of the assets of the company must be persons over whom the court can exercise jurisdiction.

9.4.3 In practice, it would normally be considered sufficient for the company to have, or have had, a place of business or a branch office or to have assets within the jurisdiction of the English court. However, other examples of where the English court has determined that there is a sufficient "connection" with the English jurisdiction include; a company having a claim against an insurer based in England; making a winding-up order which would entitle former employees of the foreign company to claim statutory redundancy payments; that the debt upon which the winding-up petition is founded was incurred within the English jurisdiction; and where the liquidator would be entitled to launch a claim against the former directors of the foreign company for wrongful trading which may subsequently produce a realisation to be distributed to creditors. It will usually be fairly clear whether or not the making of a winding-up order will potentially benefit creditors of the foreign company if the potential return will be more than *de minimis*. Likewise, the court will need to be satisfied that those who may benefit are either subject to the jurisdiction or have submitted to the jurisdiction of the English court.

9.4.4 Under the provisions of the IA 1986 there is no specific provision providing for the appointment of administrators to a foreign company (which is not subject to the Regulation) . However, as a result of other provisions contained in the IA 1986, the English court is under a duty to assist, as far as possible, a request for assistance in connection with particular proceedings which is received from a court in any other part of the United Kingdom or from any "relevant country or territory"[141]. In particular, where the English court receives a request from a relevant country or territory to make an administration order in respect of a foreign company, the relevant provisions of the IA 1986 specify that the English court to which such a request is made may apply, in relation to the issues specified in the request which it has

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[139] Section 220 IA 1986.

[140] Section 221 IA 1986.

[141] Section 426 Insolvency Act 1986. At the present time, the list of relevant countries or territories are: Anguilla, Australia, The Bahamas, Bermuda, Botswana, Brunei, Canada, Cayman Islands, Gibraltar, Hong Kong, The Virgin Islands, Malaysia, South Africa, Wales, Scotland and Northern Ireland.

received, either the insolvency law applicable in the jurisdiction of the court making the request (in relation to comparable matters falling within the English court's jurisdiction) or the normal insolvency law of the United Kingdom. This apparently wide authority is limited by the normal rules of private international law and consequently, the English court retains a discretion to refuse to provide assistance in certain circumstances (for example, where providing such assistance would prejudice local creditors).

9.4.5 However, where it is appropriate to respond to a request for the appointment of an administrator over a foreign company, the English court will have the power to make such an appointment and the administrator so appointed will enjoy the normal powers afforded to an administrator of an English company including the ability to review transactions and if necessary to apply to the court to have any transactions at undervalue or preferences set aside.

9.4.6 Of the relevant provisions concerning the enforcement of directors' duties, the English courts have confirmed that directors (whether resident in the UK or not) of a foreign company which is being wound-up by the English court will be subject to the court's jurisdiction in connection with an application by the liquidator against those directors for either wrongful or fraudulent trading.[142] This will be the case even if the country of incorporation of the relevant company does not contain an equivalent provision within its insolvency laws. However, the English court would take account of the standard of care and other duties owed by those directors in the country of incorporation of the company when deciding whether to make those directors liable for their actions. The English courts have also held that in the winding-up of a foreign company the provisions of the IA 1986 relating to transactions at undervalue and preferences will apply. It should also be noted that the provisions of section 236 IA 1986 placing directors under an obligation to provide information will apply equally to directors domiciled abroad.

9.4.7 In addition, various provisions of the CDDA 1986 relating to the disqualification of a director may be applied by the English courts. This will be the case irrespective of whether the director was resident within the jurisdiction, whether the conduct of that director took place within the jurisdiction or whether or not the director is a British citizen. This will be important for directors of foreign companies as a disqualification order may be made on the basis of "unfitness" to be a director not only as a result of wrongful or fraudulent trading but also as a result of being a director of a company which has entered into a transaction at undervalue or given a preference. A director may also be found "unfit" to be a director as a result of a breach of the various other requirements imposed on directors under the Companies Act 1985 or the IA 1986 and which are detailed in the responses to questions 2 and 3 above.

[142] *Re Howard Holdings Inc* [1998] BCC 549.

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 It is permissible for a director to take out insurance against misfeasance claims and the company may lawfully pay the premiums[143]. The company may also lawfully indemnify any director in respect of the cost of defending any proceedings (whether criminal or civil) in which judgment was given in his favour[144].

10.2 The insurance policy cannot enable the director to insure against his own wilful or fraudulent wrongdoing as it will be struck down on grounds of public policy in this regard. However, it is felt that it is possible to insure against wrongful trading. It would not, however, be possible to insure against fraudulent trading given the public policy considerations.

10.3 The main insurance policy available to directors and recommended by the Institute of Directors is the director's personal liability cover. This specifically excludes any claims based on or arising out of any insolvency proceedings and insolvency is defined in similar terms to that laid out in question 1.[145] A policy is, however, available by which directors can insure against actions arising out of insolvency, but such cover must be obtained from specialist brokers through Lloyds.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 Overview

11.1.1 The details of directors' duties are considered above at question 2. Directors, when their company is insolvent or may become insolvent, must think of the interests of the creditors of their company rather than the shareholders - as it is the creditors' money that is now at risk. The interest of the equity holders

143 Section 310(3) Companies Act 1985
144 Section 310(3)(b) Companies Act 1985
145 Information obtained from Chubb Insurance Limited, the official insurers recommended by the Institute of Directors.

has vanished. So, for example, while a transfer of assets at less than full market value may, when a company is solvent, be ratified by the shareholders (they can in a sense do what they like with their money - although note that they cannot make an illegal return of capital, see *Aveling Barford -v- Perion*), in the case of insolvency or potential insolvency the breach of duty inherent in the sale at less than market value cannot be ratified by the shareholders. This is the position at common law but is also reflected in the clawback provision under section 238 IA 1986 in connection with transactions at undervalue (see question 4 above). Similarly, generally speaking some creditors should not be paid ahead of others (the law of preferences - the successor to the Roman Paulian action).

11.1.2 Usually the most difficult decision for directors is whether to incur more credit. English law tackles this in two, not entirely, compatible ways. The main focus of attention as described at question 2 above, is the question of whether it can be said there is a <u>reasonable</u> (objectively considered) prospect of the company avoiding an insolvent liquidation. If that is not a reasonable prospect then the directors will be liable unless they do everything to minimise losses to creditors. But suppose doing the best by creditors is to conduct a process of selling crucial assets as a going concern without going into an insolvency procedure. Yet to do so will involve incurring more credit to keep the business going. It is of little comfort to a creditor who comes into the picture for the first time by supplying goods during this period to know that the creditors who were already owed money at the critical point are going to get a better dividend on their debts as a result of the continued trading and sale as a going concern. Where it can be said that the director is dishonest in incurring the credit - knowingly going beyond what a reasonable man of business would regard as honest - then he will be fraudulently trading even though doing his best for the general body of creditors.

11.1.3 English law therefore seeks to strike a balance between the need to stop directors running their companies at the expense of creditors and exploiting them and, on the other hand, not putting undue pressure on directors in what is a very difficult time. Directors need to be strong but not reckless. They need robust, helpful, legal advice but must be stopped from believing in “pie in the sky” schemes.

11.1.4 In practice, in England, well-advised directors will get independent professional help on the legal and accounting sides to bolster any decision they make to carry on trading.[146] They will get on top of the financial position of the company - perhaps for the first time: just how often is it that a significant part of a company’s problem is its failure to understand its own financial position. They will develop a plan of recovery with their accountants and seek the support of their creditors (often banks and major suppliers). Lawyers will assist in ensuring that board meetings are held regularly to consider responsibly and objectively the company’s position and its prospects and document these in the minutes of the meetings.

[146] It will not be enough to take advice if that advice is predicated on the directors' honest and reasonable belief that the company will be able to avoid insolvent liquidation if, in the light of the directors' actual knowledge, there is no reasonable basis for that belief: Re The Rod Gunner Organisation Ltd (Rubin v Gunner) [2004] All ER (D) 05

11.2 Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period?

11.2.1 The risk of dealing with a company which is or may become insolvent is that most legal systems, and English law is no exception, have a vulnerability period running back from the moment the insolvency procedure commences. In English law, the main periods are six months for preferences and two years for transactions at undervalue. Other heads of attack have no such time limit, for example, section 423 IA 1986 - transactions defrauding creditors - or cases where directors have been acting in breach of duty and this is something of which a counterparty dealing with the company is fully aware. We look at the two main statutory clawback provisions.

11.3 Preferences

11.3.1 The law here is concerned with the clawback of payments and the over-turning of security. There are two philosophical approaches to the doctrine of preference. Remarkably, English and U.S. law are quite different in their approach although this has not been greatly remarked upon. The American approach is to encourage the survival of the company by striking down transactions out of the ordinary course but allowing repayments in accordance with the practice of the business hitherto. In England, the focus is on what the directors are subjectively trying to do. If pressure is operating on the mind of the directors - pressure from creditors who threaten winding-up proceedings for example - then it is unlikely that the directors are going to be motivated by a 'desire' to put any particular creditor in a better position but are in fact likely to be simply trying to ensure their own survival. This encourages creditors to put pressure on a company in trouble, the opposite of the effect in the United States.

11.3.2 What is the practical reality for a creditor considering the preference law? The practical answer almost always will be: 'take the money/security'. It may well be hard to show what the subjective intention of the directors was and particularly to show that it was to benefit a particular bank or other creditor. Why should the director want to achieve that end? Where the director had given a personal guarantee to that creditor the answer may be all too obvious, but in the absence of those incriminating circumstances preference law in the U.K., certainly on the basis of the leading first instance decision of *Re M.C. Bacon,* has few teeth.

11.4 Transactions at an undervalue

11.4.1 The law quite properly wishes to prevent a company dissipating its assets at less than market value where that will reduce the dividend to creditors. But how can a counterparty wishing to buy assets from a company facing insolvency know that a liquidator or administrator will not try and set the transaction aside if an administration or liquidation does indeed ensue? Well, the answer is that he does not know. If the price is less than market value, then unless the transaction is for other reasons in the interests of or benefit to the company and for the purposes of its business carrying on, it is likely to be attacked. English law has not fully resolved what the court will do where it finds undervalue but common sense suggests that in most cases the counterparty will be expected to make up the difference in value.

11.4.2 Thus, in many cases a robust counterparty will ‘do the deal’ (i.e. complete the transaction) and fight any attack by a liquidator or administrator later. If they have got a very keen price which is insupportable then they have to expect they might have to disgorge the benefit. The difficulty probably arises where they buy a business in substantial need of investment and they are concerned that the court may in fact reverse the entire transaction. However, where someone has altered their position and further invested it seems hard to believe the court would seek to reverse the transaction when there is an alternative simply to require a cash payment to make up the undervalue. A practical answer is to seek comfort that the directors have taken proper professional - often accounting but perhaps also legal - advice on their position and confirmation that the directors are satisfied that the transaction is in the interests of the company. A solvency certificate would be useful if the company is not actually insolvent at the time or as a result of the transaction. In practice that is unlikely to be forthcoming. The temptation may well be to say that the deal can only be done with an insolvency practitioner and require the company to go into a formal insolvency procedure but again that can often damage the goodwill of the business or render key contracts or assets liable to termination and may harden the attitude of counterparties to such key contracts who might otherwise have been prepared to agree to a sale or assignment to a purchaser.

APPENDIX

Summary of primary English insolvency procedures

1. Introduction

1.1 When a corporate borrower faces insolvency there are a variety of insolvency options available, some of which are open to the company and some of which are only open to its secured creditors.

1.2 There are four principal insolvency regimes for English companies:

(a) receivership (including administrative receivership);

(b) voluntary arrangements and schemes of arrangement with creditors;

(c) administration; and

(d) liquidation (also known as winding-up).

1.3 Receivership may be classified as a self-help remedy for secured creditors. Voluntary arrangements involve compromises of the companies' debts with its creditors which can be statutory and formal or out of court arrangements. Administration and liquidation are the formal statutory procedures for dealing with companies which are insolvent.

2. Receivership

2.1 Although in certain circumstances, often arising out of litigation, the court may appoint a receiver for specific purposes, in English insolvency law when the term receiver is used it is almost always taken to mean the appointment of someone to enforce security given by a company to those to whom it has obligations - normally its bankers. If the holder of the security has the power to appoint a receiver or administrative receiver under the terms of the security (see paragraph 2.3 below) and that power has arisen (for example on default by the borrower to make payment), then the charge holder may appoint a receiver or administrative receiver to take control of the assets and/or business of the borrower without the need for any authorisation of the court.

2.2 An administrative receiver (not to be confused with an administrator) is someone appointed over all or substantially all the assets of a company under debentures secured by charges which include a floating charge. The significance of a receiver being an administrative receiver rather than an ordinary or non-administrative receiver is two-fold. First, there are certain powers and certain duties affecting specifically an administrative receiver under the legislation and, secondly, where an administrative receiver has been appointed, no administrator may be appointed unless the secured creditor consents. (See paragraph 4 below)

2.3 Since 15 September 2003, the ability of the holder of a floating charge to appoint an administrative receiver has been severely curtailed.[147] Unless one of a limited number of exceptions applies or the floating charge was created prior to 15 September 2003, the secured creditor will be prohibited from appointing an administrative receiver. Instead, the secured creditor will be able to appoint an administrator as a means of enforcing its security (see paragraph 4 below). The significant commercial difference between administrative receivership and administration, insofar as the secured creditor is concerned, is the level of control which the creditor has (which is greater in a receivership) and the more rigid statutory objectives of administration (see paragraph 4 below).

2.4 An administrative receiver's functions are to realise the assets and property charged and to repay the charge holder the amounts due to it after deduction of his costs, expenses and remuneration and, in the case of floating charge assets, after having paid the preferential creditors (the categories of preferential debts are set out in schedule 6 IA 1986 but are, primarily, employee liabilities). An administrative receiver or non-administrative receiver (who has been provided with management powers) may continue to trade the company's business prior to a sale on a going concern basis.

2.5 Receivership is not an "insolvency proceeding" for the purposes of the EC Insolvency Regulation and so the appointment of a receiver or administrative receiver in the UK would be outside the scope of the Regulation; the receiver would not automatically be recognised in other Member States pursuant to the Regulation. Recognition and the ability of the receiver to take possession of assets located in other Member States would be a matter of the private international law of the Member State concerned.

3. Voluntary arrangements

3.1 Where a company is essentially profitable but its debt burden and interest burden is too great, it may be able to persuade its creditors to convert some of their debt into equity and to continue funding the company. This is a simple example of a restructuring which might be effected through a voluntary arrangement or a scheme of arrangement. Arrangements can be pursued through the formal procedures set out in the IA 1986 and the Companies Acts, but a restructuring can also be effected on a simple contractual basis and most rescue and support operations are conducted out of court in that way.

4. Administration

4.1 Administration is a procedure pursuant to which a company and its business may be rescued, reorganised or its business and assets realised under the protection of a statutory moratorium (a protective breathing space from creditor action). It is loosely modeled on the American chapter 11 procedure though it is dangerous to take this analogy too far.

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[147] Section 72A IA 1986. This section became effective on 15 September 2003, the date when the new corporate insolvency provisions of the Enterprise Act 2002 came into force.

4.2 The corporate insolvency provisions of the Enterprise Act 2002, which came into force on 15 September 2003, have had a significant impact on the administration regime. In particular, the Enterprise Act 2002 introduced two new out-of-court routes into administration for (I) the company and (ii) a "qualifying floating charge-holder" (see paragraph 4.4 below). The objective was to enable administrators to be appointed more quickly, cheaply and efficiently than before and, in particular, to provide an easy out-of-court route for secured creditors in place of appointing of administrative receivers. Tighter timeframes for the administration process and a new power for the administrator to make distributions, with the leave of the court, to unsecured creditors have also been provided for.

4.3 An administrator may still be appointed by the court on the application of a creditor (including a secured creditor), the directors of the company or the company itself. The court will decide at a hearing whether the order should be made and it may only be made if the company is insolvent, or likely to become so, and the court is satisfied that the administration order is reasonably likely to achieve the purpose of administration. The purpose of administration is to rescue the company as a going concern, to achieve a better result for the company's creditors as a whole than would be likely if the company were wound up or to realise property in order to make a distribution to one or more secured or preferential creditors.

4.4 As noted above, an administrator may now also be appointed without involving the court (i.e. out of court) by the holder of a "qualifying floating charge" or by the company itself or its directors. The holder of a "qualifying floating charge" must hold security, which includes a floating charge, over the whole or substantially the whole of the assets of the company and which meets certain drafting requirements. A qualifying floating charge holder can appoint if the floating charge is enforceable – the company need not necessarily be insolvent. The company and directors can only appoint if the company is unable to pay its debts.

4.5 If a creditor, the company or the directors wish to appoint an administrator (either via the court or out of court), notice of their intention to appoint must first be given to any holder of a qualifying floating charge. This enables the floating charge holder to get in first with an out-of-court appointment of an administrator of its choosing or, if not prohibited, the appointment of an administrative receiver (see paragraph 2 above) thereby blocking the proposed appointment of the administrator. The qualifying floating charge holder is required only to give notice of its intention to appoint to any prior qualifying floating charge holder.

4.6 The purpose of administration is the same whether the administrator is appointed out of court or by the court – refer to paragraph 4.3 above.

4.7 Regardless of who appoints, the administrator effectively displaces the directors in running the company and he is required to produce proposals within eight weeks of his appointment, which he must put to a meeting of the creditors within ten weeks of his appointment, detailing how he proposes to achieve the purpose of administration. The administrator must perform his functions in the interests of the company's creditors as a whole although he may not include in his proposals any action which would affect the right of any secured creditor to enforce his security without that secured creditor's consent. This is subject to the specific powers granted to an administrator referred to in paragraph 4.8 below.

4.8 The administrator may use assets subject to a floating charge as if they were not subject to that charge, save only that any proceeds representing the floating charge assets are themselves again subject to the floating charge. With the sanction of the court the administrator may sell fixed charge assets free of the fixed charge, subject only to accounting to the fixed charge holder for market value or, if greater, the sale proceeds actually received. The effect for a secured creditor is, therefore, loss of control.

4.9 One important feature of administration is that, on the presentation to court of an administration application or the filing in court of a notice of intention to appoint an administrator, a statutory moratorium on creditor action (without the leave of the court) comes into effect. The statutory moratorium is continued, in nearly identical terms, if the company goes into administration. The prohibition covers peaceable re-entry by a landlord, distraint, the levying of execution, the repossession of leased goods and the taking or continuing of proceedings and it also includes the enforcement of security.[148] The only enforcement of security which may take place is that a creditor entitled to appoint an administrative receiver may (subject to the prohibition referred to in paragraph 2.3 above) do so on being notified of the application to court to appoint an administrator or the notice of intention to appoint an administrator out of court. The appointment of an administrative receiver has the effect of preventing the appointment of an administrator. No other enforcement of security may take place and, if an administrative receiver is not appointed before the administrator has been appointed, no enforcement of security (including the appointment of an administrative receiver) may then take place. Effectively, the secured creditor has one chance to appoint his administrative receiver (if not prohibited from so doing) or to choose who is appointed as administrator.

4.10 There is one set of circumstances in which the court may still make an administration order, notwithstanding the fact that an administrative receiver has been appointed by secured creditors. If the security under which the administrative receiver has been appointed is vulnerable, either as a preference or under section 245 IA 1986 or as a transaction at an undervalue the court may discharge the administrative receiver and make an administration order.

4.11 Administration is available only as main proceedings, and not secondary proceedings, under the EC Insolvency Regulation.

Liquidation

5.1 Liquidation (or winding-up) is the dissolution procedure for companies under English law. In that sense, it might be thought similar to Chapter 7 in the United States ('Bankruptcy' is a term applied only to individuals in England, never to companies).

148 There is an exception for certain types of security over "financial collateral" (very broadly, cash, share and tradeable bonds) if the security is taken within the context of a "security financial collateral arrangement" within the meaning given to that expression in the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) which implement in the UK the Financial Collateral Directive (Directive 2002/47/EC).

5.2 Liquidation can be in one of two forms. First, it can be a voluntary liquidation which occurs where the shareholders of the company pass a resolution to place the company into liquidation and, where the company is insolvent, a meeting of creditors will be called to confirm the identity of the person to be appointed as liquidator of the company. This procedure will be known as a creditors' voluntary liquidation. Alternatively, the company or a creditor may present a petition to the court for a compulsory winding-up, and if the company is insolvent, a winding-up order will be made by the court in due course. Liquidation has long been the standard dissolution procedure for English companies and the recent insolvency legislation has changed few of the basic rules. There is no freeze on enforcement of security by creditors.

5.3 Liquidation proceedings, voluntary and compulsory, can be opened as main or secondary proceedings but the confirmation of the court must be obtained to the opening of voluntary proceedings if automatic recognition in other Member States is required under the EC Insolvency Regulation.

FRANCE

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

Overview

1.1.1 For the purposes of assessing the vulnerability of transactions to attack (as opposed to the possible personal liability of directors), the twilight period is in practice known in France as the "suspect period" (*la période suspecte*)[1]. The suspect period is, therefore, the period during which certain transactions entered into by a company are vulnerable to attack. Under French law this period is distinguished from the period during which transactions entered into by a company are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company.

1.1.2 The date on which the suspect period is deemed to begin is that on which the company first became unable to pay its debts as they fell due or, to use the French terminology, in a state of cessation of payments – a cash-flow test.

1.1.3 The determination of the date on which the company first became unable to pay its debts (and therefore from when the suspect (twilight) period commenced) is made in one of three ways (in each case by the court with jurisdiction over the insolvency proceedings):

(a) the court finds in its judgment opening the formal insolvency proceedings that the date is the same as the date of the opening of the proceedings . In such a case, there is no suspect or "twilight" period.

(b) the court finds, as a question of fact, that the date occurred prior to the date of its order to open formal insolvency proceedings.

(c) subsequent to the order to open formal insolvency proceedings, the court, on its own motion or upon application by the court appointed administrator, the representative of the creditors, the court appointed liquidator or the Public Prosecutor, decides to revisit its original determination on the basis of new facts and modifies the date of *cessation de paiements*.

1.1.4 The suspect or twilight period ends on the date the tribunal orders the opening of formal insolvency proceedings.

1.1.5 Except in respect of transactions made for no consideration, the maximum

[1] Articles L.621-7 and L.621-107 of the Commercial Code (formerly, Articles 9 and 107 of Law n° 85-88 of 25 January 1985 as amended by Law n° 94-475 of 10 June 1994 (the "French Insolvency Law") which has recently been codified into the Commercial Code)

duration of the suspect or twilight period is 18 months[2]. This period is not calculated as a function of the nature of the act in question. The maximum period of 18 months applies notwithstanding that the actual date of *cessation de paiements* is determined to be earlier.

1.1.6 With respect to transactions made for no consideration, the suspect or twilight period may be extended for up to an additional period of 6 months prior to the date of *cessation de paiements*.

1.1.7 The duration of the period during which transactions entered into by the company are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company is not specifically determined by law. Each of the different types of transactions in question is considered in more detail in response to question 4. In certain circumstances, the risk of liability arises only after the date of *cessation de paiements.* In other circumstances, instead of questioning whether the company is in a state of *cessation de paiements*, French law considers whether there is a causal link between the reprehensible act and the commencement of insolvency proceedings in respect of the company. There is in the latter type of situation, therefore, no formal period during which transactions are vulnerable.

1.2 Summary

1.2.1 If a company is cash-flow insolvent and, within a vulnerability period thereafter (maximum eighteen months or twenty-four months in the case of transactions without consideration), goes into formal insolvency proceedings, certain specifically defined transactions may or must be declared null and void.

1.2.2 On the other hand, directors and/or others involved in the management of the company may be personally liable for certain types of transactions either if such a transaction is entered into during the "twilight" period or if there is a causal link between the opening of formal insolvency proceedings and the transaction in question.

QUESTION 2

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2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

(i) is any resulting liability against a director civil, criminal or both?

[2] Article L.621-7 of the Commercial Code (formerly, Article 9 of the French Insolvency Law).

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?

(iii) will liability attach to individual directors in proportion to their specific involvement?

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?

(v) what defences, if any, will be available in relation to each offence?

2.1 General

French law does not approach the question of the possible liability of directors and/or others associated with the management of a company which becomes subject to formal insolvency proceedings on the basis of the type of act in question. Rather French law starts from the point of view of the types of causes of action available against such persons for which certain conditions, in terms of the behaviour of the director and/or others associated with the management of the company, must be fulfilled. The responses to this question are therefore set forth on the basis of the different types of causes of action available, enumerating (not in all cases exhaustively, since this would be impossible, the types of behaviour concerned).

2.2 Action "*en comblement de l'insuffisance d'actif*" (to bridge the insufficiency in assets)

2.2.1 Personal liability will follow where:

(i) an officer of the company (in law or in fact) of the company has[3] made a fault in the management of the company (*"faute de gestion"*). The notion of fault in the management of the company is not specifically defined by statute. Caselaw has refined the concept to cover errors in the management of the company, lack of care (negligence) or breaches of law, regulation or the by-laws of the company. Determination of whether a *faute de gestion* has occurred is a question of fact for the courts.

(ii) the liabilities of the company exceed the value of its assets, the amount of the shortfall to be assessed at the time the court judges the liability of the director or others associated with the management of the company, but debts which arise after the opening of the formal insolvency proceedings shall not be included in the amount of the liabilities.

(iii) there exists a causal link between the insufficiency of assets and the *faute de gestion,* meaning that the faute must be found to have contributed (in the sense of caused) to the insolvent situation of the company. It is not, however, necessary that the *faute* be the exclusive cause, it only has to be one of the determining causes.

[3] Article L.624-3 of the Commercial Code (formerly, Article 180 of the French Insolvency Law).

2.2.2 If (i) to (iii) are satisfied:

(i) Liability is civil.

(ii) The person found liable will be required to pay damages to the company. It is up to the judge to decide, on the basis of the seriousness of the faute and the strength of the causal link, whether the person in question should pay damages or not. (I.e., even if (i) to (iii) of 2.2 are satisfied, the judge is not required to condemn the guilty person).

(iii) It is up to the judge to decide the amount of damages. The amount is not necessarily proportional to the level of contribution of the fault to the debts of the company. The maximum amount of damages is the total amount by which the faute resulted in the liabilities of the company.

(iv) There is no specific time limit prior to the commencement of formal insolvency proceedings during which the *faute de gestion* must have occurred. In practice, of course, the period of time is restricted by the requirement for there to be a causal link between the *faute de gestion* and the insolvency of the company. In the vast majority of cases, typically the last possible *faute de gestion* that can be committed by management, and which in fact is the faute which is most often condemned by courts, occurs when the declaration of *cessation de paiement* is not filed within the limitation period (15 days after the date of cessation of payments. Please note that the preliminary government bill which is pending to reform the French law on insolvency (referred to hereafter generally as the “preliminary bill”) proposes to increase this period up to one month).

(v) Other than the general defences of an absence of *faute* or an absence of causal link or an absence of insufficiency of assets, there are no specific defences to the action.

2.2.3 The preliminary bill as currently drafted removes the possiblity of initiating an *action en comblement de l’insuffisance d’actif* when a plan of continuation has been ordered.

2.3. Personal insolvency proceedings

2.3.1 A director or other person associated with the management of the company may be made subject to personal insolvency proceedings in the following circumstances (such proceedings being distinct from those ordered against the company itself), with the exception of the specific case where the Court orders a single insolvency proceeding against both the director and the company when the company’s asset base is fictious or mixed up with the director’s property)[4]:

(i) Prior to the commencement of formal insolvency proceedings against the company;

[4] Article L.624-5 of the Commercial Code (formerly, Article 182 of the French Insolvency Law).

(ii) The individual undertook one or more of seven different types of action, namely:

(a) used property of the company as his or her own property; this concept extends to a wide range of different types of behaviour covering most typically excessive remuneration, withdrawals from the company's bank account for personal ends, performance of renovation or other works by the company for personal ends, payment of personal expenses, etc.

(b) in the guise of the company covering his or her own acts, undertook commercial transactions in his or her personal interests; this typically applies to directors who abuse their majority position in the company and direct the company in their own personal interests.

(c) used the property or credit of the company in a manner contrary to the company's own interest for personal ends or for the ends of another company in which the director or other person associated with the management of the company has a direct or indirect interest; this type of behaviour is in practice very similar to that covered by (a).

(d) abusively and for personal ends, pursued a loss-making activity which would inevitably lead to the company falling into a situation of *cessation de paiements*; this concept covers, typically, directors who, using artificial financial methods, maintain a company afloat for the purpose of continuing to receive remuneration, to reduce the amount of a personal shareholder loan or to pay off company debts that he or she has guaranteed.

(e) kept fictitious accounts or destroyed the company's accounting books and/or records or failed to keep the company's accounts contrary to law and regulation. This covers a failure, whether full or partial to maintain the company's accounts. This is completed by the following:

(f) keeping accounts that are manifestly incomplete or irregular.

(g) misappropriating or concealing all or part of the assets of the company or fraudulently increasing the liabilities of the company. This is the most serious type of behaviour by which the individual sought to organise the insolvency of the company or to keep the assets of the company to the detriment of the company's creditors.

(iii) Although the provisions of the law do not specifically so require, typically there must be a link (if not formally so found to be causative) between the wrongful act in question and the insolvency of the company.

(iv) It has to be established to the satisfaction of the Court that acts b), c), d) were made in the personal interests of the director .

2.3.2 If (i) and any of (ii) above are satisfied:

(i) Liability is civil.

(ii) & (iii) Given the nature of the sanction, neither question is applicable. The liabilities of the personal insolvency proceedings include the personal debts of the director and all the debts of the company.

(iv) There is no specific time limit prior to the commencement of formal insolvency proceedings during which the specific wrongful action must have occurred. In practice, of course, the period of time is restricted by the "informal" requirement that there is a link between the act in question and the insolvency of the company.

(v) Other than the general defences of an absence of one or more of the specific requirements for the offence, there are no specific defences to the action.

2.3.3 The following situations may also give rise to personal insolvency proceedings against the director:

(i) A director who has been condemned for *"comblement de l'insuffisance d'actif"* and who has not satisfied that penalties imposed by the Court in respect thereof[5]. Whether such proceedings are commenced is however at the discretion of the judge.

(ii) A director who is a partner of the company, responsible jointly and severally and without limitation for its corporate debts *(associés en nom collectif, associés commandités…)*[6]. In this case no fault is required: personal insolvency proceedings will extend automatically to all the partners of the insolvent company.

2.3.4 The preliminary bill provides for the removal of these three cases of personal insolvency proceedings and the creation of a new *action in payment of corporate debts*, which would cover the same wrongful acts as those of Article L.624-5 of the Commercial Code save for those relating to fictious or irregular accounts. This new action would not require a finding of an insufficient assets and the Court would only be able to order the director to pay for all corporate debts (*i.e.,*not just part of them as the Court can do for the *action for comblement de passif)*. In other words, if the judge decides to condemn the director, he will bear liability for the whole corporate debts

2.4. Personal bankruptcy – prohibition on management

2.4.1 In addition to the possibility of extending the insolvency proceedings commenced against the company to its directors or others associated with the management of the company in paragraph 2.3 above, an individual director may be made subject to personal bankruptcy in any of the following five cases during the course of formal insolvency proceedings[7]:

(i) Having carried out the function of a director of a company when forbidden to do so;

(ii) With the intention of avoiding or delaying the opening of formal

5 Article L.624-4 of the Commercial Code (formerly, Article 181 of the French Insolvency Law)

6 Article L.624-1 of the Commercial Code (formerly, Article 178 of the French Insolvency Law)

7 Article L.625-2 of the Commercial Code (formerly, Article 186 of the French Insolvency Law) for personal bankruptcy and Article L.625-8 of the Commercial Code (Article 192 of the French Insolvency Law) for the prohibition on management.

insolvency proceedings, having made purchases with a view to resale at a higher price or having used ruinous means to obtain funds;

(iii) Having entered into, for the account of a third party, without consideration, undertakings judged to be too significant or important at the time of signature given the situation of the company

(iv) Having paid or caused to be paid, after the date of *cessation de paiements,* one creditor in preference to others. (The preliminary bill sets apart and removes from this sanction payments made within the framework of an amicable agreement approved by the Court)

(v) Having failed, within a period of 15 days, to have filed in court a declaration of the existence of a situation of *cessation de paiements*. (The period of 15 days is to be replaced by one month in the preliminary bill).

2.4.2 Although the provisions of the law do not specifically so require, typically there must be a link (if not formally so found to be causative) between the wrongful act in question and the insolvency of the company – apart from those cases where, by definition no link is necessary, e.g., in respect of (iv) and (v) above.

2.4.3 If any of (i) to (v) are satisfied:

(i) The judge is not required to condemn the guilty person. If he does, liability in both the cases of personal bankruptcy and prohibition on management is civil – albeit that they have certain characteristics of penal sanctions.

(ii) (a) The sanction of personal bankruptcy carries with it prohibition on managing, administering and controlling a commercial enterprise or any form of company which has an economic activity. A certain number of professions are also prohibited (e.g., the judiciary, the legal profession, activity as a financial intermediary, insurance agent, etc.) as well as all public functions. A person in personal bankruptcy also loses his or her political rights. (The preliminary bill currently removes this penalty).

(b) The prohibition on management is a diluted form of personal insolvency and enables the court to adapt the sanction to the particular situation of the individual. The most severe form of the sanction is the prohibition on managing, administering and controlling a commercial enterprise or any form of company which has an economic activity.

(iii) The court has discretion over the duration of the personal bankruptcy or the prohibition on management albeit the minimum period in any case is 5 years.[8]

(iv) Except in respect of (iv) and (v) of 4.1 above, there is no specific time

[8] Article L.625-10 of the Commercial Code (formerly, Article195 of the French Insolvency Law).

limit prior to the commencement of formal insolvency proceedings during which the specific wrongful action must have occurred. In practice, of course, the period of time is restricted by the “informal” requirement that there is a link between the act in question and the insolvency of the company. In respect of (iv) and (v) of 4.1 above, by definition the wrongful act must have taken place after the date of *cessation de paiements* which, as is explained above, depends upon a finding of fact by the court which opens the formal insolvency proceedings. The date cannot be more than 18 months prior to the date of the order opening formal insolvency proceedings.

(v) Other than the general defences of an absence of one or more of the specific requirements for the offence, there are no specific defences to the action. A person found liable to personal insolvency may have some or all of the prohibitions lifted if he or she can show that he or she has made a sufficient contribution to the payment of the insolvent company’s debts.

2.4.4 The following persons may also be subject to personal bankruptcy :

(i) Any director who has committed one of the acts mentioned in 2.3. as being punished by the commencement of a personal insolvency proceeding.

(ii) Any director who has been condemned to *comblement de l’insuffisance d’actif* and has not satisfied the penalty imposed. (The preliminary bill currently adds the case of the director condemned on the basis on the new *action in payment of corporate debts* who has not satisfied the applicable penalties)

(iii) Any director who has been condemned for criminal bankruptcy.

In this case, personal bankruptcy or prohibition on management is a complementary penalty decided by the Criminal Court and, can be either permanent or temporary in nature and, if the latter, must not exceed five years.[9]

2.4.5 The preliminary bill removes the distinction between the Commercial and Criminal Courts as regards the period of personal bankruptcy or prohibition on management : consequently there is no longer a 5 year minimum period and the maximum duration is 15 years.

2.5. Criminal Bankruptcy (*Banqueroute*)

2.5.1 This criminal offence may be committed in any of the following circumstances, provided that formal insolvency proceedings have been commenced in respect of the company[10]:

(i) where the person, with the intention of avoiding or delaying the opening of formal insolvency proceedings, has made purchases with a view to resale at a higher price or used ruinous means to obtain funds;

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[9] See Cass.Crim, 8 january 2003, D.2003.IR.807

[10] Article L.626-12 of the Commercial Code (formerly, Article 196 of the French Insolvency Law).

(ii) where a person has misappropriated or concealed all or part of the company's assets;

(iii) where a person has fraudulently increased the debts of the company;

(iv) where a person has kept fictitious accounts or caused accounting books and records to disappear or failed to keep accounts contrary to legal requirements.

(v) where a person has kept manifestly incomplete sets of accounts or kept accounts that do not comply with legal requirements.

2.5.2 If any of (i) to (v) are satisfied:

(i) Liability is criminal.

(ii) A person guilty of this offence is liable to imprisonment (maximum of 5 years, increased to 7 for a listed company) or a fine (maximum of 75,000 euros, increased to 100,000 for a listed company) or both.

In addition, the court can impose any of the following sanctions:

(a) deprivation of civil rights;

(b) prohibition for a maximum of 5 years on holding a public function or conducting a professional activity in the same field as that in which the offence was committed;

(c) exclusion from being permitted to bid for public tenders for a period of at least five years;

(d) prohibition for a maximum period of 5 years from issuing cheques other than those enabling the drawer to draw funds deposited with the drawee or certified cheques;

(e) publication of the judgment;

(f) Personal bankruptcy or prohibition on management.

Further if there is a civil party to the criminal proceedings, the court may award damages to the civil party provided that that party is the victim of the offending behaviour – typically the company – on the basis of the principles of tort (Articles 1382 et seq. of the Civil Code)

(iii) The gravity of the offence will be reflected in the length of imprisonment or the extent of the fine that is ordered and in the nature and extent of any of the other sanctions that may be imposed. In exercising its punitive jurisdiction, the court is not seeking to compensate the company

The amount of damages that may be awarded will depend upon the extent of the loss caused by the offending act.

(iv) Except in the case of the offence of misappropriation or concealment of assets of the company (for which the acts in question must have been committed once the company is in a state of *cessation de paiements*), there is no specific time period prior to the commencement of formal insolvency proceedings that the reprehensible acts must have been committed.

(v) Absence of intent to defraud is a defence to a charge under 2.5.1(i) and (iii). Absence of a voluntary and positive act of disposal is a defence to a charge under 2.5.1(ii).

2.6. Fraudulent organisation of insolvency

2.6.1 Any officer or associated person can be held liable for this offence if[11]:

(i) he or she fraudulently misappropriates or conceals part of his or her own personal property to avoid paying the debts of the company in insolvency;

(ii) he or she fraudulently acknowledges and accepts debts that do not exist.

2.6.2 If (i) or (ii) are satisfied:

(i) Liability is criminal. The answers to 2.5.2(ii) and (iii) are applicable.

(ii) The offence can only be committed once a company is in a situation of *cessation de paiements*.

(iii) Absence of intent to defraud is a defence.

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above.

Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors.

[11] Article L.626-14 of the Commercial Code (formerly, Article 209 of the French Insolvency Law).

3.1 Introduction

3.1.1 French insolvency law provides expressly that the liability that may attach to a formally appointed director or manager of a company extends to “de facto” managers or directors – known in French as *dirigeants de fait*. The definition of a de facto director is explained below.

3.1.2 In certain circumstances, third parties may be found liable to a company subject to formal insolvency proceedings. For example third parties who commit certain faults, in particular if their behaviour has provoked the insolvency of the company or aggravated its consequences, may be liable for the damage that they have caused.

3.2 De facto directors (*dirigeants de fait*)

3.2.1 A de facto director can be defined as a person (individual or corporate entity) who behaves as if he were a de jure director, (*e.g.:* carrying out acts that only a de jure director would be empowered to perform) without being empowered to do so. More precisely, a person can be considered a de facto director where he has become involved in the management or administration of a company without any corporate mandate, and held an active and positive decision making role in such management and administration, without restrictions and with full independence.

3.2.2 Under French law, a de facto director is generally a person who has some form of connection with the company. Typically, the person is either a member of the company (in the form of shareholder, partner, etc.), is associated (such as married) with a formal director, or is in a business relationship with the company (e.g., as a supplier, a bank or customer).

3.2.3 In all cases, the de facto director exceeds the powers that have officially and formally been given to him with regard to the management of the company’s affairs.

3.2.4 The characterisation of a de facto management situation therefore requires that two criteria are met:

(i) the management or administrative acts adopted by the de facto director shall have been carried out without restriction and in total independence, which requires that the director must have been granted an autonomous decision-making power. This requirement would imply that a de facto management situation is inconsistent with a subordination link such as may result from an employment contract (if the alleged de facto director is given orders by another person to whom he is subordinated, such other person is the real de facto director).

(ii) an active and positive decision making role, which implies that the de facto director must have directly intervened in the management of the company, behaved as the master of the business and “unofficially” run the company. There is no need to find that the person was treated as a director by the other directors. The key to the notion is the active involvement of the person in determining the management of the company.

3.2.5 Whether a person has become a de facto director or not is a question of fact. Among the factors that the courts frequently take into account are the nature of the technical functions granted to the alleged de facto director (*e.g.:* commercial management, supply management), the powers granted to him (*e.g.:* power to place orders to suppliers, to sign cheques, to hire or dismiss employees) and his behaviour (*e.g.:* the fact that he considers that the company belongs to him, that he behaves as the manager of such company).

3.3 Other third parties who may be held liable

3.3.1 Third parties who are involved with a company which enters into formal insolvency proceedings may be subject to liability in tort if all or part of the loss suffered by the insolvent company's creditors is caused by their wrongful action. The existence of a fault (tort), damage and a causal link between the two must be established by the claimant seeking recovery. Most typically this type of action is brought by the creditors of an insolvent company against the banker of the company on the basis that it contributed to the insolvent situation of the company by its dealings with it *("soutien abusif")*.

3.3.2 The loss may be general – suffered by all of the creditors – in which case only the representative of the creditors can bring the action. Alternatively the loss may be specific to one creditor in which case the action can only be brought by the injured creditor. In order to bring such a specific action, the creditor must be capable of establishing to the satisfaction of the Court the existence of a prejudice which is (i) specific and (ii) personal to him. The action is a civil action and sounds in damages (either to the company in the event of a general action or to the injured creditor in the event of an individual claim).

3.4 Actions for which liability may attach to persons not formally appointed as directors

Offence/activity	**Persons liable**	**Extent of liability**
Action *en comblement de passif*	All directors and de facto directors (whether remunerated or not)	Same as for director
Personal insolvency proceeding	All directors and de facto directors (whether remunerated or not)	Same as for director
Personal bankruptcy	All directors and de facto directors (whether remunerated or not)	Same as for director
Prohibition on management	All directors and de facto directors (whether remunerated or not)	Same as for director
Criminal Bankruptcy	All directors and de facto directors (whether remunerated or not)	Same as for director
Fraudulent organisation of Insolvency	All directors and de facto directors (whether remunerated or not)	Same as for director

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counter-party dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside.

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Introduction

4.1.1 Like many other legal systems, out of a concern to protect creditors and the company itself, French law recognises the right to bring proceedings for the nullity of certain payments and transactions made during the *période suspecte* (which, as explained above, begins with the date on which the company finds itself in a situation of *cessation de paiements* and ends on the date of the order commencing formal insolvency proceedings). The basis of concern is the fear that the company facing financial difficulties may, either on account of the unequal bargaining power that exists because of its situation or in an attempt to use whatever means it can to face up to its financial difficulties, grant certain favours and enter into certain transactions which are to the detriment of the company and/or unfairly beneficial to a creditor or counter-party and thus detrimental to the overall body of creditors.

4.1.2 The actions in nullity[12] are intended to reconstitute the assets of the company by sanctioning either the fraud committed by the company or the breach of the principle of equality between creditors. A third party contracting with the company may therefore, see the transactions that it entered into with the company during the suspect period annulled on the basis of the French insolvency law.

4.1.3 In addition to the statutory bases of the action in nullity, French civil law also recognises an action, known as the *"action paulienne"* (a right of action given by Article 1167 of the French Civil Code to the creditors of a debtor to challenge transactions or other acts undertaken by the debtor defrauding the creditors' rights). This right of action is not linked to the suspect period and can be used for example if the conditions for the statutory bases of action are not satisfied.

4.2 Summary of heads of challenge

4.2.1 The transaction or payment in question must have occurred during the suspect period (i.e., after the date of *cessation de paiements* and prior to the judgment opening formal insolvency proceedings) by the company and not by

[12] On the basis of Article L.621-107 of the Commercial Code (formerly, Article 107 of the French Insolvency Law).

a third party. It must fall within one of the seven heads of challenge enumerated in Article L.621-107 of the Commercial Code (formerly, Article 107 of the French Insolvency Law). It is not, however, necessary for an interested person bringing the action in nullity to show that the act, falling within one of the heads of challenge, has caused loss to the company. The heads of challenge fall into two different categories: (a) those which must be annulled by the court if the legal requirements are met; and (b) those which, if the legal requirements are met, may be annulled by the court.

4.2.2 The potential heads of challenge are as follows:

(a) Transactions which are null and void:

(i) Transactions undertaken by the company without consideration;

(ii) Any commutative transaction in which the company's obligations exceed those of its counter-party;

(iii) Payment of debts which are not due, by any means whatsoever;

(iv) Payments of debts which are due, but made in a manner not commonly admitted in business relationships;

(v) All deposits and consignments; made upon a court's request during the suspect period, unless such guarantees were given as a result of a definitive decision requiring such deposit or consignment issued prior to the opening of bankruptcy proceedings;

(vi) All guarantees granted over the debtor's assets for existing debts;

(vii) All conservatory measures made against the company or its assets.

(b) Transactions which may be annulled:

(i) Transactions mentioned in (a) (i) may be annulled where they have been completed during a six-month period prior to the cessation of payments. As stated above however, such transactions, if made during the suspect period (*e.g.:* after the cessation of payments date and prior to the formal opening of bankruptcy proceedings) must be annulled.

(ii) Pursuant to Article L. 621-108 of the Commercial Code, any transaction, including payments for debts that have fallen due or transactions for consideration entered into during the suspect period if the counter-party knew that the company was in a situation of *cessation de paiements*.

Each head of challenge is considered briefly below.

4.3 Transactions for no consideration

The statutory text defines such transactions as *"les actes à titre gratuit translatifs de propriété mobilière ou immobilière"* (transaction for no consideration as a result of which real or personal property is transferred). The purpose of this text, covering all forms of gift, is to avoid transactions that plainly result in a reduction in the amount of the assets of the company.

4.4 Unequal Bilateral Transactions

4.4.1 The statutory text defines such transactions as *"tout contrat commutatif dans lequel les obligations du débiteur excèdent notablemenet celles de l'autre partie"* (any bilateral "commutative" transaction in which the debtor's obligations clearly exceed those of the counter-party). A contract is "commutative" if, at the time of signature, the nature of the advantage that each party obtains from the contract can be clearly ascertained. It covers, for example, the sale of personal property, the sale of merchandise, the creation of a guarantee, the transfer of a trademark. Consequently, contracts which include an element of risk are not included in the definition.

4.4.2 The advantages drawn from the contract by each of the parties must be clearly unequal, to the detriment of the company. The difference (a) must be objectively ascertained and ascertainable (b) must, economically and mathematically, be clear and (c) there must be an element of subjectivity in the bad faith of the importance of the inequality between the two parties. Examples include the sale of horses at 2/7 of their true value; the sale of merchandise at less than two thirds of their value.

4.5 Payment of debts which have not fallen due

The statutory text defines this head of challenge as *"tout paiement, quel qu'en ait été le mode, pour dettes non échues au jour du paiement"* (any payment, regardless of the manner in which it is effected, of debts which are not due at the date of payment). The reasoning behind this head of challenge is clear, it being, of course, unusual business practice to pay debts before they fall due.

4.6 Payments not normally recognised in business relations

4.6.1 The statutory text provides: *"tout paiement pour dettes échues, fait autrement qu'en espèces, effets de commerce, virements, bordereaux de cession visés par la loi n° 81-1 du 2 janvier 1981 facilitant le crédit aux entreprises, ou tout autre mode de paiement communément admis dans les relations d'affaires"* (any payment for debts that have fallen due made in a manner other than in cash, bills of exchange (and the like), wire transfer, global transfer of credits in accordance with Law 81-1 of 2 January 1981 facilitating credit to enterprises, or any other method of payment commonly recognised in business relations).

4.6.2 The purpose is to avoid payments that, on account of the unusual nature, grant an advantage to one creditor over the mass. The notion of payments commonly recognised in business relations covers any method of payment which professionally is generally and habitually used in the appropriate field of business affairs.

4.7 Deposits and consignments

4.7.1 The statutory text provides: *"tout dépôt et toute consignation de sommes effectués en application de l'article 2075-1 du Code Civil, à défaut d'une décision de justice ayant acquis force de chose jugée"* (any deposit or consignment of monies effected pursuant to Article 2075-1 of the Civil Code unless made pursuant to a final and binding court ruling). Article 2075-1 of the Civil Code relates to any deposit of consignment of sums of money, bills of exchange and the like, or securities which an entity has been ordered to make as a guarantee or as a conservatory measure.

4.7.2 The purpose behind the challenge to all such types of transactions is because of the priority right that such deposit or consignment grants to a creditor over and above the general body of creditors in accordance with Article 2073 of the Civil Code.

4.8 Creation of guarantees for existing debts.

4.8.1 The statutory text provides: *"toute hypothèque conventionnelle, toute hypothèque judiciaire, ainsi que l'hypothèque légale des époux et tout droit de nantissement constitués sur les biens du débiteur pour dettes antérieuresment contractées"* (any mortgage whether contractual, judicially ordered or pursuant to law as between spouses, and any pledge over property of the debtor granted for pre-existing debts). The text covers, therefore, all forms of security over property, whether real or personal. The key is the date on which the security was granted as compared to the date on which the debt in question was incurred by the company. If the latter is prior to the former, and if the guarantee has been granted during the suspect period, the action for nullity must succeed.

4.8.2 Again the reasoning behind this head of challenge is clear given the absence of any justifiable rationale for granting security over a debt that already exists, such security not having been a sine qua non condition for the creation of the obligation. Accordingly, the purpose of granting an advantage to the creditor in question through the giving of additional or new security is presumed.

4.9 Conservatory measures

4.9.1 The statutory text provides: *"toute mesure conservatoire, à moins que l'inscription ou l'acte de saisie ne soit antérieur à la date de cessation de paiements"* (any conservatory measure unless the filing or the act of seizure took place prior to the date of cessation of payments).

4.9.2 The purpose of this is to protect the company against conservatory measures obtained by a creditor against the company which would have the effect of giving that creditor an advantage over other creditors. The reasoning behind this head of challenge is similar to that underlying the nullity of security granted for existing debts.

4.10 Nullity of transactions for no consideration relating to real and personal property, implemented during a six month period prior to the cessation of payments

4.10.1 If made during the suspect period, such acts must be annulled. However, if made during the six month period preceeding the cessation of payments date (i.e., and as a consequence, the suspect period), such acts may be annulled.

4.10.2 Knowledge by the counterparty of the fact that the debtor is in a date of cessation of payments is not required.

4.11 Nullity when the counter-party was aware that the company was in a state of *cessation de paiements*

4.11.1 Unlike the other forms of the action in nullity, this head of challenge is at the discretion of the judge. The statutory text[13] provides: *"les paiements pour dettes échues effectués après la date de cessation de paiements et les actes à titre onéreux accomplis après cette même date peuvent être annulés si ceux qui ont traité avec le débiteur ont eu connaissance de la cessation des paiements"* (payments for debts that have fallen due after the date of *cessation de paiements* and transactions for consideration entered into after that date may be annulled if the person dealing with the debtor was aware of the *cessation de paiements*).

4.11.2 Consequently, the transaction or payment in question must have taken place during the suspect period. There is no need to show that the company has suffered loss as a result. The purpose of the head of challenge is to reconstitute the assets of the company in an attempt to assist recovery. The key element to this head of challenge is the counter-party's knowledge that it was dealing with a company which was in a state of *cessation de paiements*. It is not enough that the counter-party knew that the company was in financial difficulties. It must be shown that it knew that the company was unable to meet its debts as and when they fall due. Fraudulent intent is therefore necessary.

4.11.3 Given that this head of challenge is within the judge's discretionary, the tendency is for the courts to take into account the seriousness of the bad faith and fraudulent intent of the creditor.

4.12 Action Paulienne

This action which is based on Articles L. 621-107 and L. 621-108 of the Commercial Code may not be brought by a creditor, but only by the representative of creditors and the administrator (acting jointly or individually).

If however, the administrator or a representative of the creditors fails to bring an action, Article 1167 of the Civil Code entitles any creditor to challenge transactions made defrauding its rights. This right of action is available regardless of the existence of a state of *cessation de paiements*. Fraudulent intent must be shown to have existed on the part of the counter-party to the transaction with the company – such fraudulent intent aimed at harming the creditor. If fraudulent intent can be shown to exist and if the creditor can show that it has a valid and existing debt against the company, it can request that the transaction be annulled.

[13] Article L.621-108 of the Commercial Code (formerly, Article 108 of the French Insolvency Law).

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above) and before which Courts?

5.1 Introduction

5.1.1 The persons who may bring proceedings, whether civil or criminal, against the directors or associated persons are defined in the statutory texts.

5.1.2 Actions for *comblement de passif*, personal insolvency proceedings, personal bankruptcy and prohibition on management can only be brought by the liquidator, administrator or creditors' representative appointed by the court in the course of the formal insolvency proceedings, the public prosecutor or the court on its own motion. Where the Court has ordered a plan of reorganisation, the person appointed by the Court in charge of the execution of the plan *(commissaire à l'exécution du plan)* can also bring actions for *comblement de passif* and personal insolvency proceedings. These civil actions are brought before the Commercial Court *(Tribunal de Commerce)* with jurisdiction over the insolvency proceedings against the company.

The preliminary bill proposes to modify the current rules in the following way: the administrator, the *commissaire à l'execution du plan* and the Court would no longer be able on their own motion to initiate a civil action; creditors specially appointed to help the creditors' representative or the liquidator during the proceedings (*créanciers contrôleurs*) would be able to initiate any of the four civil actions but only where the creditors' representative or the liquidator has not done so. The new civil action in payment of corporate debts would follow the same rules as the other civil actions.

5.1.3 The criminal actions grounded on bankruptcy *(banqueroute)* or on organisation of insolvency may only be brought by the public prosecutor, the liquidator, the administrator, the creditors' representative, the employees' representative or the person appointed by the Court to execute the plan of reorganisation or, by any person initiating a civil action at the same time *("Constitution de partie civile")*. These criminal actions are brought before the *Tribunal Correctionnel*. A creditor can also initiate a civil action if the criminal action has already been brought and if he is able to establish an individual specific loss different from the amount of his debt and resulting directly from the offence.

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court.

Offence	Remedy available
Comblement de passif	Liability is civil The director or associated person may be ordered to compensate for all or part of the insufficiency in assets that his fault in management has contributed towards.
Personal insolvency proceedings	Liability is civil. The director or associated person will be subject to insolvency proceedings. The nature and result of such insolvency proceedings may be different from that ordered against the company.
Personal bankruptcy	Liability is civil The director or associated person will be prohibited from managing, administering and controlling any commercial enterprise and any form of company which carries on an economic activity. He or she shall also be prevented from conducting certain professions such as the judiciary, legal profession, financial intermediary, insurance agent. He or she shall be deprived of his or her civil and political rights.
Prohibition on management	Liability is civil. The director or associated person will be prohibited from managing, administering and controlling any commercial enterprise and any form of company which carries on an economic activity. The court may limit such prohibition to certain sectors of activity.
Bankruptcy	Liability is criminal. The maximum penalty is five years imprisonment and /or a fine up to 75,000 euros (seven years and 100,000 euros for investment service providers) In addition the director or associated person may be sanctioned by any of the following orders: • deprivation of civil rights; • prohibition for a minimum period of 5 years on having a public function or conducting a professional activity in the same field as that in which the offence was committed; • exclusion from participating in public tender offers for a period of at least 5 years; • prohibition for a period of at least five years on issuing certain forms of cheque; • publication of the judgment. If civil proceedings are associated with the criminal proceedings, the director or associated person in question may be ordered to compensate for any loss that his offending conduct has caused.

Fraudulent organisation of insolvency	The same as for bankruptcy.
Actions in nullity	Liability is civil. The payment or transaction which is annulled is thus rendered null and void. The asset transferred pursuant to the annulled transaction or payment must be returned to the company.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any obligations (e.g., in the UK and other European jurisdictions Article 6 of the European Convention on Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Obligation to commence insolvency proceedings

7.1.1 French law imposes a duty on the legal representative of a company (i.e., the President of the Board of Directors in a traditional *société anonyme*, the President of the management board *(directoire)* of a two-tier managed *société anonyme*, the manager *(gérant)* of a *société à responsabilité limitée*) which is in a state of *cessation de paiements* to hold a meeting of the workers' representatives (e.g., the workers' council where this exists or the personnel delegates where a workers' council does not exist) and inform them of the situation and thereafter, within 15 days of the state of *cessation de paiements* occurring, to file a declaration of *cessation de paiements* at the registry of the commercial court where the company is registered. The government bill proposes to extend the 15 day period to one month.

7.1.2 Given that the other members of the management, such as the directors or the members of the management board, are liable along with the legal representative if the declaration of *cessation de paiements* is not made within the 15 day period (thus being exposed to the sanctions of personal insolvency or prohibition to manage, even though such persons do not themselves have the authority to file the declaration), typically the filing of the declaration of *cessation de paiements* is made by the legal representative in close co-operation with the other members of the management of the company in question.

7.1.3 The declaration should contain:

(i) the last available annual financial accounts of the company;

(ii) an excerpt of the registration of the company;

(iii) a recent (no more than three months old) statement of the cash flow position of the company;

(iv) the number of employees of the company;

(v) the company's net turnover for the last financial year;

(vi) a statement of the amounts due and owing to and by the company and the names and addresses of the creditors and debtors;

(vii) a statement of the guarantees granted to and by the company and all off-balance sheet liabilities;

(viii) a summary statement of the assets of the company;

(ix) when judicial liquidation is requested, all elements necessary to demonstrate that the company has ceased activity or that the re-establishment of the company is impossible;

(x) the names and addresses of the representatives of the workers' council (where on exists) and the employee delegates (where no workers' council exists) empowered to represent the personnel of the company.

7.1.4 It should be noted that insolvency proceedings may also be commenced in a number of different ways by persons other than the legal representative of the company (for instance by one or more creditors of the company, by the public prosecutor or by the courts by their own motion).

7.2 Participation in the initial steps of the proceedings

7.2.1 Prior to the court determining whether a company is in a state of *cessation de paiements,* whether requested by the legal representative for the declaration of *cessation de paiements*, upon a writ of action by a creditor, an originating summons by the public prosecutor or by the court of its own motion, the court must carry out a preliminary investigation. As part of the preliminary investigation, the court must summons the legal representative of the company to be heard. The participation of the legal representative in the initial investigation is of course of utmost importance given the knowledge and understanding of the difficulties faced by the company that such person would normally have.

7.2.2 In addition to summoning the legal representative of the company, the court must also summons the representatives of the personnel (i.e., workers' council representatives or if no workers council exists the personnel delegates) as well as any other person who can provide the court with information as to the actual situation in which the company is placed.

7.3 Right to be heard during the proceedings

7.3.1 Throughout the insolvency proceedings, the legal representative of the company has numerous specific rights to intervene either before the administrator, the *juge commissaire* or the court.

7.3.2 Examples include Article L.621-56 of the Commercial Code (formerly, Article 20 of the French Insolvency Law) which provides that the legal representative of the company must be consulted by the administrator, once the latter has been appointed by the court, to inform him or her as to the situation and the prospects for the successful reorganisation of the company, the ways in which the company's debts can be paid off and the social conditions in which the company's activities may be pursued. Again, Article L.621-62 of the Commercial Code (formerly, Article 61 of the French Insolvency Law) provides that the court must summon the legal representative of the company when, following the expiry of the observation period, it rules on the future of the company – either judicial liquidation or one or more forms of reorganisation (continuation or transfer).

7.4 Obligation to collaborate during the proceedings

7.4.1. Given that the legal representative of the company is often the person best placed to know and understand the company and its activity, his or her collaboration with the judicial organs/officers instituted to conduct the insolvency or the reorganisation proceedings is invaluable. French law thus provides for the close involvement of the legal representative of the company in all stages of the proceedings.

7.4.2 Article L.621-54 of the Commercial Code (formerly, Article 18 of the French Insolvency Law) provides that, under the general regime, the administrator appointed by the court must draw up a report setting forth the economic and social situation of the company. Such statutory text specifically provides that the legal representative must collaborate with the administrator in this process. The report must identify the origin, significance and nature of the difficulties affecting the company. The administrator must also propose in the report either a programme for the reorganisation of the company or its judicial liquidation. For companies subject to the simple regime where no administrator is appointed, the report is drawn up by the legal representative.

7.4.3 Article 69 of the Decree of 27 December 1985 provides that within eight days of the judgment opening the insolvency proceedings, the legal representative of the company in question must, if a list is not attached to the declaration of *cessation de paiements*, prepare and deliver to the creditors' representative or, if the judicial liquidation of the company is immediately ordered, to the liquidator, a list setting forth the names and addresses of the creditors of the company, the amounts due and owing at the date of the commencement of the insolvency proceedings, the amounts becoming due and on what date, the nature of the debts and any guarantees or charges relating thereto. The creditors' representative or the liquidator must then file the list with the court. Failure, in bad faith, to provide the list within the 8 day period exposes the legal representative of the company to the penalty of prohibition to manage, administer or control a legal entity (Article L.625-5 of the Commercial Code).

7.4.4 The legal representative of the company (and the other members of the management organ) retains the power to call meetings of the shareholders whenever required in the course of the insolvency proceedings (for example when the reorganisation programme involves a modification of the share capital of the company) (Article L.621-58 of the Commercial Code, formerly, Article 22 of the French Insolvency Law). In the event of a failure by the legal representative to call any such shareholders' meeting, the administrator has the power to do so.

7.4.5 At the request of the administrator, the legal representative of the company must perform all steps and acts necessary to preserve the company's rights against its debtors and to preserve the production capabilities of the company (Article L.621-16 of the Commercial Code, formerly, Article 26 of the French Insolvency Law).

7.5 Rights granted to the legal representative

7.5.1 The legal representative of the company has the right (*locus standi*) to request the *juge commissaire* to seize the court with a view to replacing the administrator or expert(s) appointed by the tribunal (Article L.621-10 of the Commercial Code, formerly, Article 12 of the French Insolvency Law).

7.5.2 At any time during the proceedings, the legal representative has the right *(locus standi)* to file a request with the court for the total or partial cessation of the company's activities or the judicial liquidation of the company (Article L. 621-27 of the Commercial Code, formerly, Article 36 of the French Insolvency Law).

7.5.3 The legal representative has the power on behalf of the company to challenge any decisions taken by the judicial organs during the procedure that by law are open to challenge (for example against the decision of the *juge commissaire* to admit, reject or contest debts of the company in the course of the insolvency proceedings (Article L.621-105 of the Commercial Code, formerly, Article 102 of the French Insolvency Law)).

7.5.4 The legal representative has the right *(locus standi)* to request that the court extend the observation period (Article L.621-6 of the Commercial Code, formerly Article 8 of the French Insolvency Law) or the application of the general regime to a company initially placed under the simple regime (Article L.621-134 of the Commercial Code, formerly Article 138 of the French Insolvency Law).

7.5.5 Throughout the observation period following the commencement of the insolvency proceedings, the legal representative has a right to be informed by the administrator of the progress of his mission.

7.5.6 The creditors' representative must seek the legal representative's observations on the proposals to admit or reject or contest before the court the debts owed by the company and duly declared by the creditors (Article L.621-103 of the Commercial Code, formerly, Article 100 of the French Insolvency Law).

7.5.7 The court must summon the legal representative of the company before it takes any decision with respect to the extension of the observation period (Article 20 of the Decree of 27 December 1985), the modification of the mission granted to the administrator (Article 54 of the Decree of 27 December 1985), to order the judicial liquidation of the company following the commencement of an observation period (Article L.621-27 of the Commercial Code, formerly, Article 36 of the French Insolvency Law), or to order a plan of reorganisation (Article L.621-62, formerly Article 61 of the French Insolvency Law).

7.5.8 It should be noted that the rights granted to the legal representative are broader under the simple regime than under the general regime because under the former a number of the rights and obligations granted to the administrator are vested in the legal representative. Thus, for example, it is the legal representative of the company who must draw up the draft re-establishment plan which must be submitted to the court at the end of the observation period (Article L.621-139 of the Commercial Code (formerly, Article 143 of the French Insolvency Law).

7.6 Rights retained by the legal representative

7.6.1 In the event that the court orders the immediate judicial liquidation of the company at the commencement of the proceedings, the legal representative of the company is immediately stripped of all rights of action, power and authority with respect to the activity of the company. All such rights of action, powers and authorities are vested in the judicially appointed liquidator.

7.6.2 In all other cases, the legal representative remains at the head of the company with varying degrees of power and authority over the conduct of the activities of the company depending upon the nature of the mission granted to the judicially appointed administrator in the general regime or subject to the involvement of the *juge commissaire* in the simple regime.

7.6.3 The principal powers retained by the legal representative are twofold – namely, the power to take conservatory measures and the power to undertake acts in the ordinary course of business.

(i) The power to take conservatory measures. Conservatory measures in this context means those measures necessary to protect the rights of the company and to preserve the production capabilities of the company. Measures to protect the rights of the company include acts to stop statutes of limitation from running, sending out formal letters before action *(mises en demeure)* to debtors, and the creation or renewal of guarantees, charges and the like. Measures to preserve the company's production capabilities include the renewal of the company's stocks, replacement of used or worn material, repair of damaged machinery and acts to prevent the theft or other wrongful disappearance of the assets of the company.

(ii) The power to undertake acts in the ordinary course of business of the company. Article L.621-23 of the Commercial Code (formerly Article 32 of the French Insolvency Law) provides that "acts taken in the ordinary course of business alone by the legal representative are deemed valid vis-à-vis third parties acting in good faith". Acts in the ordinary course of business in the sense of Article L.621-23 of the Commercial Code are those which fall within the scope of the normal business activity of the company, which are of such a nature as to be reproduced on a regular and frequent basis, which do not have a significant financial impact on the company and which would not be likely to be detrimental to the reorganisation of the company. Examples include issuing orders for office supplies of minor financial significance, issuing orders for materials necessary for the conduct of the company's business in amounts typical for the company, and the sale of goods typically sold by the company on normal terms and conditions. The third party must be in good faith which means that it must not be aware of any restrictions on the legal representative of the company from undertaking the act in question. It is not however usually necessary for the third party to have undertaken any specific investigation into the powers and restrictions actually affecting the legal representative to prove its good faith.

7.6.4 The extent and nature of the other powers of the legal representative with respect to the activities of the company in question depend upon the nature of the mission granted to the administrator. It should be noted that the description of the mission granted to the administrator by the court when it opens an observation period with respect to any given company is noted on the register of the company and filed with the court clerk of the competent commercial court. The mission granted to the administrator falls within three broad categories in accordance with Article L.621-22 of the Commercial Code (formerly, Article 31 of the French Insolvency Law) – namely, supervision, assistance or representation.

(i) A mission of supervision. This is the situation where the legal representative retains the widest powers over the management of the company. The legal representative must simply ensure that he or she does not commit any acts that are specifically forbidden by the Law (see below) and does not encroach upon the powers which, by definition, are vested in the administrator. Apart from the foregoing caveats, the legal representative of the company retains the power to act alone during the observation period with respect to the management of the company. His actions are simply subject to an ex-post facto control by the administrator.

(ii) A mission of assistance. A mission of assistance results in a situation of co-management of the company by the legal representative and the administrator, subject always to the caveat that those acts specifically forbidden by the Law cannot be undertaken (see para. 7.7 below). In practice, this type of mission means that the acts undertaken by the legal representative (other than those which the legal representative can always undertake (see para. 7.6.3 above)) are systematically verified and approved by the administrator before they are made. Thus the administrator will be involved in all decisions to enter into new contracts, to order significant amounts of material or merchandise, to issue letters of credit, etc. The court may alleviate the burden of this type of involvement of the administrator in the management of the company by limiting the need for assistance and thus co-management to specific types of acts – generally those considered to be the most important or significant for the company.

(iii) A mission of representation. A mission of representation granted to an administrator is the most severe from the point of view of the legal representative of the company in question who, apart from those acts which he or she can always undertake (see para. 7.6.3 above), is to all intents and purposes stripped of his or her power to manage the company, such power being vested in the administrator during the observation period.

7.7 Acts that the legal representative cannot undertake

7.7.1 The acts that the legal representative cannot undertake fall into three broad categories: those which are forbidden as a general rule; those which are forbidden under the general regime and those that are forbidden in the simple regime.

7.7.2 Those acts which are forbidden to be undertaken by the legal representative as a general matter are the following.

(i) The legal representative cannot reimburse debts which existed prior to the commencement of the insolvency proceedings, any such reimbursement being at risk of being annulled (Article L.621-24 of the Commercial Code (formerly, Art. 33 of the French Insolvency Law)). Except for a very limited number of exceptions specifically provided for by the Law, the reimbursement of any such debts must be approved beforehand by the *juge commissaire*.

(ii) The legal representative cannot undertake any acts that fall outside the ordinary course of business of the company in question (Article L.621-24 of the Commercial Code (formerly, Art. 33 of the French Insolvency Law)). This prohibition is of course the corollary to the right of the legal representative to undertake acts that fall within the ordinary course of business of the company noted above. If such an act, such as the sale of assets (as opposed to stock) of the company or entering into a settlement of a dispute, becomes necessary, it must be approved beforehand by the *juge commissaire*.

(iii) The legal representative is prohibited from granting any form of security over the assets of the company without the prior approval of the *juge commissaire*.

7.7.3 Under the general regime, in addition to the general prohibitions described above, the following restrictions apply to the acts that the legal representative can undertake:

(i) The legal representative cannot take any decision regarding the continuation or cessation of existing contracts binding the company to its customers or suppliers; that right of decision being vested in the administrator.

(ii) The legal representative cannot take any decision regarding making personnel redundant for economic reasons. Again that right of decision is vested in the administrator.

(iii) The administrator alone has the authority to permit the payment of goods purchased prior to the commencement of the insolvency proceedings but subject to a reservation of property clause. The special treatment of this situation, which amounts to the payment of a pre-existing debt and which is therefore generally prohibited by the French Insolvency Law, lies in the fact that without the payment of the totality of the purchase price the seller could exercise its rights under the reservation of property clause and thereby obtain possession of the goods in question thus endangering the chances of success of the insolvency proceedings.

7.7.4 The following is a recapitulative table of paragraph 7.7.3:

Prohibited acts	**- Payment of pre-existing debts**
Acts requiring prior approval of the *juge commissaire*	- Sale of operating assets - Grant of security - Redundancies - Settlements
Administrator's powers	- Continuation/termination of existing contracts - Payments under agreements subject to a reservation of property clause
Shared powers	Mission of supervision: - Ex-post facto verification by the administrator Mission of assistance - Co-management Mission of Representation - Management vested in the administrator
Unrestricted acts	- Conservatory measures - Acts in the ordinary course of business

7.7.5 Under the simple regime, when an administrator is not appointed, the powers of the legal representative are limited by the *juge commissaire* in the following manner.

(i) The legal representative must obtain the approval of the *juge commissaire* before continuing to perform a contract that binds the company to its customers or suppliers. Two situations can arise. Either the legal representative of the company indicates to the *juge commissaire* spontaneously his or her wish to continue performing an agreement after the commencement of the insolvency proceedings. In this event, the legal representative must act quickly since, unless expressly continued, all contracts binding upon the company prior to the commencement of the proceedings are automatically terminated one month after [a notice questioning the representative on its intention to continue the contract has been sent?]. Alternatively, if the legal representative decides not to continue a particular agreement, he or she may simply cease to perform the agreement immediately after the opening of bankruptcy proceedings without the intervention of the *juge commissaire*. The agreement would be terminated, the counter-party to the agreement having no right to require performance by the company.

(ii) Redundancies for economic reasons cannot be made without the prior approval of the *juge commissaire*. Any redundancy must fulfil three conditions, namely it must be urgent, inevitable and indispensable (Article L.621-37 of the Commercial Code (formerly, Article 45 of the French Insolvency Law).

(iii) The prior approval of the *juge de commissaire,* for the same reasons noted above (see para. 7.7.3(iii)), is required before any goods purchased subject to a reservation of property clause can be paid for.

7.7.6 The following is a recapitulative table of paragraph 7.7.5:

Prohibited acts	**- Payment of pre-existing debts**
Acts requiring the prior approval of the *juge commissaire*	- Sale of operating assets - Grant of security - Continuation of contracts - Redundancies - Payment of price under agreements subject to a reservation of property clause - Settlements
Unrestricted acts	- Conservatory measures - Acts in the ordinary course of business - Termination of agreements

7.8 Human Rights

7.8.1 France is a contracting party to the European Convention for the Protection of Human Rights and Fundamental Freedoms (Treaty of Rome, 4 November 1950) (the “Convention”) the provisions of which are incorporated into French law.

7.8.2 The persons identified in response to question 3 will accordingly be entitled to rely upon the rights contained in the Convention (the “Convention Rights”). This is the case whether such persons are individuals or companies. In an insolvency context, a legal representative, director or other person with Convention Rights under the Convention will be able to:

(i) require that a particular provision of insolvency law is construed in accordance with those Rights or otherwise declared incompatible; or

(ii) claim that the judicial organs are each a public authority and acting unlawfully in breach of that person’s Convention Rights.

7.8.3 It should be recognised that the Convention Rights are not absolute and may well be limited by authorised interference by the state where interference is justified and/or proportionate to the need in hand.

7.8.4 In the context of insolvency, and the duties of co-operation discussed above, certain Convention Rights may be particularly relevant. These include:

(i) Article 6 – the right to a fair trial;

(ii) Article 4 – prohibition of slavery and forced labour;

(iii) Article 8 – right to respect for private and family life;

(iv) Protocol 1, Article 1 – right to the peaceful enjoyment of possessions.

7.8.5 Caselaw on the application of the Convention to insolvency proceedings is however particularly scarce in France.

QUESTION 8

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8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower court.

8.1 Limitation periods

Limitation Period for Criminal Proceedings

8.1.1 Bankruptcy and fraudulent organisation of insolvency fall within the category of offences known as *délits correctionnels* and therefore the applicable limitation period is three years. Article L.626-16 of the Commercial Code (formerly, Article 211 of the French Insolvency Law) provides that the limitation period starts to run only from the date on which formal insolvency proceedings have been initiated. Should the facts of bankruptcy or insolvency organisation occur after the commencement of formal insolvency proceedings, then according to most of the commentators, the three-year limitation period should start, pursuant to general principles of criminal law, on the date on which these facts were discovered.

Limitation Period for Civil Proceedings

8.1.2 Actions for *comblement de passif* are statute-barred three years after the date on which the court orders the plan of reorganisation within the context of the formal insolvency proceedings or, failing such an order, the date on which the court orders the judicial liquidation of the company.

Since the preliminary bill has suppressed the possibility of initiating such an action in case of a plan of continuation, the three-year limitation period will start from the date on which the Court orders the resolution of the plan of continuation or the judicial liquididation. On the contrary, the new *action of payment of corporate debts* which can be brought where a plan of continuation has been adopted, will be statute-barred three years after the date on which the court adopts the plan of continuation or, failing such an order, the date on which the court orders the judicial liquidation of the company.

8.1.3 Actions in extension of insolvency proceedings are in principle also statute-barred three years after the date on which the court orders the plan of reorganisation within the context of the formal insolvency proceedings or, failing such an order, the date on which the court orders the judicial liquidation of the company (except for the specific case where the extension is the penalty applied in the case of a non execution of a condemnation to *comblement de passif* : there is no specific limitation period other than the formal closing of insolvency proceedings) .

8.1.4 No specific limitation period is provided for in the French Insolvency Law for actions grounded on personal bankruptcy or the prohibition on management. Given that these actions relate to personal sanctions, it is considered by a number of commentators that instead of the general 10 year limitation period applicable to commercial actions, the thirty year limitation period applicable to personal actions should apply. The fact that there is no case-law on the issue demonstrates that this is a highly theoretical issue. However, most of the commentators consider that the action must be brought before the formal closing of insolvency proceedings.

The preliminary bill provides for a five year limitation period.

8.2 Appeals

Appeal in Criminal Proceedings

8.2.1 Appeal from a decision at first instance (before the *"correctionnel"* court) in respect of *délits correctionnels* is to the Court of Appeal of the district in which the court at first instance was sitting. Where the director is present at the hearing at which the judgment is rendered at first instance, the delay for appeal is 10 days from the date of the judgment. Alternatively the 10 day period runs from the date on which the judgment is served on the director.

Appeal in Civil Proceedings

8.2.2 Appeal is before the Court of Appeal of the district in which the first instance court was sitting. Appeal is of right and is a re-hearing of the case at first instance. The appeal must be filed within one month of the date on which the judgment at first instance is served on the director. Appeal normally suspends the execution of the attacked judgment, unless provisional execution is of right or ordered by the first instance court.

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations.

9.1 Jurisdiction of the French courts

9.1.1 The tribunal which has jurisdiction over civil actions brought against directors is the one with jurisdiction over insolvency proceedings.

The French Tribunal Correctionnel has jurisidiction over criminal actions against directors of a company under formal insolvency proceedings commenced in France. Therefore it is essential to determine which court has jurisidiction over insolvency proceedings.

In all cases, a French Court will implement French Law, i.e

(i) the EC Regulation for the European insolvency proceedings[14], and

(ii) international Treaties or Article 1 and 163 of the French Decree implementing the French Insolvency Law[15] for the international non-European insolvency proceedings.

9.1.2 European insolvency proceedings

Since 31 May 2002, EC Regulation *(règlement communautaire)*1346/2000 has replaced the former regulation i.e international Treaties and provisions of Article 1 of the French Decree, pursuant to principles of superior authority and immediate enforcement of European Regulations in domestic Law. This Regulation applies to “European Insolvency Proceedings”, (i.e Insolvency of a company[16], which has its headquarters, “the centre of its main interests” in one Member State of EC, and has one or more establishments in another Member State, all pre-expansion Member States being concerned, except Denmark). Therefore, French Courts can have jurisdiction in two different cases with distinct consequences :

(i) when a company has the centre of its main interests in France, French Courts will have jurisdiction over a Principal Insolvency Proceeding;

(ii) when a company has one or more *establishments* in France but the centre of its main interests is in another Member State, the French Courts have jurisdiction only over a Secondary Insolvency Proceeding.

14 EC Regulation 1346/2000 dated 29/5/2002, enforced since 31/5/2002

15 Decree 85-1388 dated 27/12/1985 implementing the French Insolvency Law

16 Banks and insurance companies are excluded and the Insolvency must involve the appointment of an administrator (art1. EC Regulation)

For a Principal Insolvency Proceeding to be commenced in France, the company must have *the centre of its main interests in France*., which is deemed –subject to contrary evidence- to be the place of its statutory registered office. This Principal Insolvency Proceeding is said to be “international” or “universal” : it aims at reaching all the assets of the company located in any State Member party to the Regulation; The decisions of the French Court are on principle recognised of right and therefore enforceable in all the Member States, without the necessity of any exequatur; all the creditors, regardless of their nationality, are entitled to prove their debts before the French Court in the Insolvency Proceedings.

If the company has the centre of its main interests in another Member State, a Secondary Insolvency Proceeding can be opened before the French Courts provided that the company has one or more *establishments* in France. As a matter of principle, a Secondary Insolvency Proceeding can only be commenced in France after Principal Proceedings have been commenced in the State where the registered office of the company is located. However, a Secondary Insolvency Proceeding might be opened in France independently from a principal proceeding abroad if it is required by a *local creditor* (a creditor who has his residency or registered office in France, or whose claim arises from the activity of the establishment) or if the local law of the State where the registered office is located does not allow there insolvency proceedings to be commenced against the company in question.

An *establishment* is defined as any place where the debtor conducts a regular business activity involving human and material resources for this activity. It may be an office or a branch but not a subsidiary because an establishment has no juridical personality. An affiliate would thus be subject to a Principal Insolvency Proceeding.

The Secondary Insolvency Proceeding is said to be “territorial”. Its effects are limited to the State of the establishment as regards the assets of the Company, but all the creditors, regardless of their nationality are entitled to declare their debts before the Court in charge of the proceeding. Furthermore, if a principal insolvency proceeding has been commenced in the State where the registered office is located, the secondary insolvency proceeding opened in France can only be a judicial liquidation.[17]

Only these two criteria of the *centre of the main interests* and of the *establishment* give jurisdiction to French Courts under EC Regulation, which is a significant change from the former applicable law. French Courts no longer have jurisdiction with respect to Articles 14 and 15 of the Civil Code when the applicant or the respondent is a French national, and when the company has no establishement in France but only assets or contractual relations. It should be noted that the EC Regulation does not provide for the jurisdiction and law applicable to proceedings initiated against directors of the company on the grounds of bankruptcy proceedings. French Courts have however recently ruled that the Court which opened the bankruptcy proceedings has jurisdiction over such actions (*i.e.: Action en comblement de passif,* personal insolvency proceedings) even where directors sued are

[17] See Versailles, 4 September 2003, D.2003.n°34 p2352

foreign nationals[1]. [The French Court with jurisdiction over the insolvency proceedings can no longer order a personal insolvency proceeding against directors who have not performed their penalty to bridge the insufficiency of assets or against directors who are also partners responsible jointly and severally and without limitation for corporate debts.]

9.1.3 International non-European Insolvency Proceedings

These proceedings are not included in the scope of application of the EC Regulation : they cover cases where a company has interests both in France and in a State which is not a party to the EC Regulation as well as those specially excluded from the application of the EC Regulation (insolvency proceedings without appointment of an administrator, banks and insurance companies). Since the EC Regulation has abrogated the bilateral Treaties with other Member States of the EU, only the Treaty with Monaco is still applicable. Therefore, the applicable Law for international non-European insolvency proceedings is according to the principles set forth in Articles 1 and 163 of the 85-1388 Decree implementing the French Insolvency Law as interpreted by the Courts.

Article 1 of the Decree provides that the French Courts will have jurisidiction if the registered office of the company is located in France. The notion of “registered office” is construed as the actual decision making and administrative centre of the company (the effective registered office) and not the literal meaning of the term, namely, the office registered at the Trade and Companies Registry (the statutory registered office)[18]. However in practice, the statutory registered office is assumed (subject to contrary evidence) to be the effective one, as under EC Regulation.

9.1.4 Article 1 of the Decree also provides that the French Courts have jurisdiction when the company has its registered office abroad but one of the centres of its interests is located in France, which means in practice an establishment with no juridical personality. The insolvency proceedings are then said to be “subsidiary”, which corresponds to the secondary insolvency proceeding of the EC Regulation. A subsidiary proceeding can be opened in France independently of an insolvency proceeding opened in the country where the company has its registered office and can even reach a different solution to the same issue as the courts in the other country.

The commencement of insolvency proceedings abroad in respect of a such company will not prevent the commencement of insolvency proceedings against that company in France unless the foreign judgment has already been recognised and received an order of *exequatur* from a French court:

The jurisdiction of the French Courts over insolvency proceedings is more extensive than under EC Regulation. Caselaw admits that the French Courts have jurisdiction over insolvency proceedings for any company which has only business relations, assets like buildings[19], or even business facilities rented

[1] See Cass. Com. 5 May 2004, société Rewah c. Walczak, Dictionnaire permanent enterprises en difficultés, Bull. 250, n° 5289.

18 See Amiens, 15 December 1989, GP.1990.som.315; Cass.Civ 21 july 1987, Rev.Soc.1988.97

[19] See Cass.Com 1st October 2002, Act.Proc.Coll.2000/18,n°243

under a leasing agreement[20] in France. Moreover, Articles 14 and 15 of the French Civil Code grant a privileged jurisdiction to the French Courts if the demanding or defending Party is a French national. For example a French Court may decide to start a personal insolvency proceeding against a company having its registered office in the USA and no establishment in France, when this company is a partner jointly and severally responsible and without limitation for the debts of a French company under insolvency proceedings[21].

A principal insolvency is said to be universal: it includes all the assets of the company throughout the world. However, the French judgment must be recognised by an order of *exequatur* from the Court of the State in which the assets are located (while under the provisions of EC Regulation, recognition is automatic). A judgment within a subsidiary proceeding has no chance of being recognised in the State of the registered office, which is why the effects of subsidiary proceedings are said to be *territorial* only.

All creditors regardless of their nationality can declare their debts before the Court in charge of the insolvency proceedings, whether the proceedings are principal or subsidiary.

All causes of action arising under French insolvency law will be available[22], regardless of where the assets or persons in question are situated, but will require a judgment of exequatur from the foreign country where the assets or the persons are located in order to enforce any order obtained. Theoretically, therefore, a foreign director could be held liable for *comblement de passif* and transactions undertaken during the suspect period with a foreign counterparty (i.e., after the date of the *cessation de paiements*) would be either treated by the French courts as null and void (if falling within the provisions of Article L.621-107 of the Commercial Code) or at risk of being annulled if the conditions of Article L.621-108 of the Commercial Code are met (see question 4 above). A French Court may also order a personal insolvency proceeding against a foreign director who has not performed his penalty for *comblement de passif*[23], or who is a partner jointly and severally responsible and without limitation for the Company's debts, which is no longer possible under EC Regulation.

QUESTION 10

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10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above.

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20 See Cass.Com 26 October 1999, Act.Proc.Coll. 2000, n°279
21 See Dijon, 11 April 1995, Droit des sociétés, juin 1998 p12
22 Article 163 of 85-1388 Decree implementing the French Insolvency Law
23 See Cass.Com, 14 March 2000, Bull.Joly 2000 p600n°132

10.1 It is permissible under French law for a company to take out insurance and pay the premiums in respect of the civil liabilities that its directors may incur in the course of the performance of their duties. Typically insurance policies of this type cover the directors' civil liability resulting from faults, errors, omissions, mistakes and false interpretations of legal or regulatory texts. An insurance policy can cover civil claims arising out of insolvency proceedings. It is however becoming more common for these types of insurance policies to exclude claims for *comblement de passif*.

10.2 As a general matter, it is not permissible for any person to insure against penal liabilities regardless of the nature of the sanction. Hence insurance cannot be obtained against bankruptcy, for example. Similarly, the insurance policy will typically exclude any form of fraudulent behaviour, even if the liability is civil in nature.

10.3 Given that the directors covered by the insurance policy must be identified therein, in practice the civil liability of a de facto director cannot be insured.

QUESTION 11

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11. How safe is it for directors and others to incur further credit during the twilight period

11.1 Overview

11.1.1 The details of the duties of directors and de facto directors are considered above in the response to question 2. As noted, French law does not focus on types of transactions but rather sanctions directors (and persons in similar de facto positions) for particular types of conduct. In other words, if a director incurs further credit during the twilight period, the risk of the director being exposed to liability depends upon the circumstances in which and the reasons for which the further credit was incurred, rather than in the type of transaction through which the credit was obtained.

11.1.2 Consequently, if by incurring further credit, the director, for instance, commits an act of mismanagement (e.g., there was no good reason for the company to incur the credit) or did so for his or her own personal ends and not for the benefit of the company, he or she would be exposed to an action *"en comblement de insuffisance d'actif"* or personal bankruptcy, respectively.

11.1.3 A director must therefore be sure of the reasons for entering into any new transaction once the company is in a situation where, from a cash-flow point of view, the assets of the company are or risk being insufficient to cover its debts as they fall due.

11.1.4 Given the technical nature of the definition of *"cessation de paiements"* and the fact that the date on which the company actually fell into a state of *cessation de paiements* may be fixed retroactively (up to 18 months before the commencement of the formal insolvency proceedings), it is possible for a manager to be running a company in a state of *cessation de paiements* without knowing that this is the case. Directors should therefore be particularly careful of their intentions when entering into new transactions whenever the company is facing financial difficulties.

11.1.5 In practice, in France, well-advised managers will get independent professional help, whether from insolvency practitioners, legal professionals, accountants and/or from the courts in voluntary reorganisation proceedings to assist them in any difficult decisions they may make to avoid insolvency. They will also often seek the support of their creditors and in particular their banks and major suppliers.

11.2 Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period

11.2.1 Articles L.621-107 and L.621-108 of the Commercial Code (formerly Articles 107 and 108 of the French Insolvency Law) provide for a series of different types of acts which are, either obligatorily or at the discretion of the court, null and void if undertaken during the "twilight" or, in French terminology, "suspect" period – a period which, as noted above, can extend to 18 months prior to the date of the commencement of formal insolvency proceedings or 24 months in the case of transactions undertaken for no consideration.

11.2.2 The types of transaction which are automatically null and void if entered into during the twilight period are described in the response to question 4 above. Hence, it is clear that a party transacting with a company that is or is likely to be in a situation of *cessation de paiements* must avoid each of the seven types of transaction listed in Article L.621-107 of the Commercial Code. Failure to do so will result in the automatic nullity of the transaction and the concomitant measures of restitution required against the third party. It should be noted that the causation of a loss to the company is not a condition for the applicability of Article L.621-107 of the Commercial Code, neither is the bad faith or any form of wilful intent or knowledge that the company is in a state of *cessation de paiements* on the part of the third party.

11.2.3 Again as noted above in response to question 4, the courts have a discretion to avoid any transaction if entered into during the twilight period in circumstances where the other party was aware that the company was in a state of *cessation de paiements.* The apparently draconian nature of this power is tempered by the need to show that the counter-party was aware not only that the company was in financial difficulties but that it was in the technical and special position its assets were less than its debts due and payable.

APPENDIX A

SUMMARY OF FRENCH INSOLVENCY PROCEDURES

1. Introduction

1.1 When a company faces insolvency there are a variety of insolvency options available under French law.

1.2 Prior to formal insolvency proceedings being commenced with the filing by the legal representative of the company of the declaration of *cessation de paiements* (or the commencement of such proceedings by a third party creditor, the public prosecutor or the court of its own motion), there are a number of ways in which, with or without the assistance of the court, a company can attempt to recover from its situation of financial difficulty. In addition to the various private aids and agreements that can be entered into with shareholders, creditors or employees, these possibilities fall into the following principal categories:

(i) Public assistance/aid;

(ii) Voluntary reorganisation *(règlement amiable)*;

(iii) Appointment of a *mandataire ad hoc*;

(iv) Appointment of an *administrateur provisoire*.

1.3 Thereafter, if any of the foregoing actions fails to prevent the company from falling into a situation of *cessation de paiements*, formal insolvency proceedings will follow one of two different regimes – the simple regime or the general regime, determined largely by the size of the company in question. The two major differences between the two regimes are the appointment of an administrator in the general regime where typically no such judicial officer is named in the simple regime and the duration of the proceedings which is shorter in the simple regime.

1.4 Unless the judicial liquidation of the company is declared immediately, the initial phase of the proceedings will consist of an observation period during which the judicially appointed organs and officers, the legal representative of the company and the creditors will seek to determine the best alternative for the company (reorganisation or liquidation) followed by a ruling by the court on the type of reorganisation programme or liquidation that should be followed. There are two different types of reorganisation programme which can be combined:

(i) Continuation;

(ii) Transfer.

2. Public assistance

2.1 Public assistance may be either direct in the form of loans or subsidies or indirect in the form of extensions of deadlines for payment or tax relief. Such assistance is most typically granted by the administrative organs of the state albeit that other local or regional public organisations are also involved in supporting and assisting companies in difficulty.

2.2 Restructuring Committees have been established by the central government whose role is to assist industrial companies which find themselves in financial difficulty by offering financial support to help bear the burden of measures of restructuring or reorganising which must be set forth in a clear and defined programme designed to save the company. These Restructuring Committees therefore offer a form of direct assistance.

2.3 The Commission des Chefs de Services Financiers et des Responsables d'Organismes de Sécurité Sociale ("The Commission of the Heads of Financial Services and the Managers of Social Security Organisms") has the authority, upon motivated request either by the company itself or by one of the Restructuring Committees, to grant delays for the payment of tax and social security debts. The Commission includes the Directeur des Impôts, the Director of the Banque de France, the Director of Social Security and the Director of the URSSAF.

3. Voluntary Reorganisation (*règlement amiable*)

3.1 The process of voluntary reorganisation applies to companies which are not in a state of *cessation de paiements* but which face financial difficulties. It is based upon the appointment of a conciliator by the competent commercial court and is aimed at the conclusion of an agreement between the company and all or part of its creditors with a view to restructuring the company's financial situation.

3.2 The procedure is initiated by the legal representative of the company filing a request with the competent commercial court, setting forth the financial, economic and social situation of the company, its financing needs and its means of meeting them.

3.3 The court has considerable investigative powers including the possibility of obtaining bank and financial information so as to establish a complete and accurate picture of the situation in which the company finds itself. The court can also appoint an expert to assist it in this information gathering task with a view to drawing up of a report. It should be noted that the whole procedure is covered by the obligations of professional secrecy. Thus, any expert's report is available to the company but not to its creditors.

3.4 If the court considers that the situation of the company and the proposals made by the directors of the company so permit, the court will formally open the process of *règlement amiable* and appoint a conciliator for a period not exceeding three months which period may be extended by a maximum of one additional month at the request of the conciliator. The court will address the conciliator about the information that it has obtained, including any expert's report, during its initial inquiry.

3.5 The conciliator may request that all judicial actions initiated or to be initiated against the company be suspended if he or she considers that this will facilitate the process of concluding an agreement between the company and its creditors. The duration of any such suspension ordered by the commercial court cannot exceed the duration of the mission of the conciliator. The decision to suspend proceedings automatically carries with it an order on the company not to pay all or part of any debt pre-dating the decision of suspension (other than the salaries of its employees) and not to undertake any acts that are outside the ordinary course of business, including the grant of any additional security.

3.6 As noted above the purpose of the process of the *règlement amiable* is to facilitate with the assistance of the conciliator the conclusion of an agreement between the company and its creditors to enable the company to meet its debts and improve its financial situation. If an agreement is reached it is approved formally by the court and filed at the companies registry. It should be noted that the agreement may be reached with the company's principal creditors alone (i.e., not with all creditors), in which event the commercial court may grant extensions of payment in respect of other creditors, including fiscal authorities. For the duration of the agreement, the company's creditors are prohibited from pursuing any form of judicial action against the company aimed at obtaining payment of their debts.

3.7 Failure by the company to comply with the agreement reached with its creditors results in the agreement becoming null and void and all payments covered thereby becoming immediately due and payable. In such a situation it is common for formal insolvency proceedings to be commenced either by the court of its own motion or upon the application of a creditor.

4. Appointment of a *mandataire ad hoc*

4.1 The appointment by the competent commercial court of a *mandataire ad hoc* over a company is designed to deal with a specific situation in which the company in question finds itself as opposed to a general problem of financial or economic difficulty.

4.2 The *mandataire ad hoc* is appointed by the competent commercial court upon application of the legal representative of the company. The appointment is made at the discretion of the court which defines the specific mission to be carried out by the *mandataire*. The legal representative of the company retains all of his or her prerogatives notwithstanding the appointment of the *mandataire*, in particular with respect to the management of the company.

4.3 Typically a *mandataire ad hoc* would be appointed in a situation where the company needs to negotiate, for example, extensions of payment with one or two specific third parties and not the whole mass of creditors. The duration of the functions of the *mandataire ad hoc* is not limited by law and thus occasionally, given the very short duration of the mission that can be granted to a conciliator in the *règlement amiable* procedure, a *mandataire ad hoc* may be chosen by the commercial court instead of the *règlement amiable* where a longer duration of mandate is thought to be necessary and the number of creditors in question is not too large.

4.4 Any agreement entered into by the company following the intervention of the *mandataire ad hoc* is not, unlike under the *règlement amiable*, approved by the court and operates like any other agreement. It does not therefore, unless provided for in its terms and conditions, automatically result in the suspension of judicial proceedings and cannot be unilaterally extended to persons who are not parties to it.

5. Appointment of an *administrateur provisoire*

5.1 The appointment of an *administrateur provisoire* is appropriate for situations where a company is left, to all intents and purposes, without its management. This can arise for a variety of reasons including the existence of a deadlock among the managers or shareholders of the company in question. The role of the *administrateur provisoire* is therefore to assume conduct of the full management of the company. The *administrateur provisoire* represents the company vis-à-vis third parties. He or she can represent the company before the courts, operates the bank accounts of the company, draws up all financial statements and has the power to call shareholders' meetings.

5.2 Albeit that the appointment of an *administrateur provisoire* is not necessarily linked to the existence of financial difficulties affecting a given company, this procedure is by its nature in fact frequently associated therewith. For instance, the *administrateur provisoire* also has the power to file a declaration *de cessation de paiements* if the company finds itself in a situation of *cessation de paiements*.

5.3 At the end of his mission, the *administrateur provisoire* must file a report of his actions with the court.

6. Formal insolvency proceedings

6.1 Formal insolvency proceedings must be commenced by the legal representative of the company in question filing a declaration of *cessation de paiements* (colloquially referred to as the *dépôt du bilan*) within 15 days of the date on which the company falls into a state of *cessation de paiements*. The sanctions to which the legal representative may be exposed if he or she fails to respect such delay are set out above in response to question 4.

6.2 Formal insolvency proceedings may also be commenced by a creditor issuing a writ of summons, by a request filed by the public prosecutor or by the competent commercial court of its own motion.

6.3 The competent commercial court (being that where the company is registered) first embarks on a preliminary investigation as to whether and if so when the company fell into a state of *cessation de paiements* and whether the company has ceased activity or is incapable of being reorganised.

6.4 If the court comes to the decision that the company has either ceased activity or is incapable of being reorganised, it will immediately issue an order for the judicial liquidation of the company. The purpose of the proceedings thereafter is not to redress the company but to obtain the most profit from the sale of the assets of the company to pay off the company's debts. The company management is immediately stripped of all authority which instead is vested in the court appointed liquidator. It is the liquidator, with the assistance of the court, that proceeds with the sale of the assets of the company and pays off the company's creditors.

6.5 In the event that the court determines, following its preliminary inquiry, that the judicial liquidation of the company is not necessary, it opens the observation period and appoints the various judicial officers who will conduct the investigation into the most appropriate manner in which to reorganise the company.

6.6 There are two possible regimes under which the reorganisation procedure may be conducted: the simple regime and the general regime. The simple regime applies to all companies which satisfy the two following criteria: at the date of filing the request for the commencement of the insolvency proceedings, the company employs fewer than 51 employees and had a turnover in the last completed financial year of 12 months of less than FRF 20 million (Euro 3.1 million).

It should be noted that the court has the power at any time to apply the general regime notwithstanding that any given company satisfies the criteria for the simple regime depending upon, *inter alia*, the complexity of the problems affecting the company.

6.7 The judicial officers appointed by the court to conduct the proceedings are:

(i) a *juge commissaire* who is appointed at the very opening of the proceedings to oversee the progress of the procedure and to accelerate it if necessary. The role of the *juge commissaire* is more significant in the simple regime given the absence usually of an administrator.

(ii) a *mandataire judiciaire*, known as the creditors' representative in a reorganisation process or the *"mandataire à la liquidation des entreprises"* in a judicial liquidation process whose role is to verify the debts of the company, to represent the creditors in any judicial actions and to verify the assets of the company in the event of a judicial liquidation.

(iii) an *administrateur judiciaire, or administrator*, who typically is only appointed if a company becomes subject to the general regime. His or her role is to carry out the mission (of either supervision, assistance or representation) granted by the court.

(iv) the *contrôleurs* who are appointed by the *juge commissaire* from among those of the company's creditors who so request to oversee the various operations of verification made by the other court appointed officers.

(v) the *représentant des salariés* who is not appointed by the court but by the employees of the company upon the request of the court and whose role is to verify the amount of wages overdue and unpaid as part of the list of debts of the company.

(vi) the *représentants du personnel* who in fact are the company law representatives of the employees (either the workers' council or the personnel delegates) who are to be consulted by the tribunal on the principal decisions to be taken throughout the proceedings.

6.8 The observation period lasts for six months in the general regime, renewable once only for an additional six month period by the court. In the simple regime, the observation period is four months, renewable once only for an additional period of four months.

6.9 During the observation period, the company continues to function with its management being supervised, assisted or represented by the administrator in the case of the general regime or under the control of the *juge commissaire* in the case of the simple regime.

6.10 It should be noted that at any time during the observation period, the court can order the transfer of all or part of the activity of the company or its judicial liquidation.

6.11 During the observation period the administrator (in the general regime) or the legal representative of the company (in the simple regime) must draw up a statement of the financial situation of the company together with his or her proposal for the reorganisation (or judicial liquidation) of the company.

6.12 If the court so orders, the reorganisation of the company can take one of two forms, or a combination of them both: namely, the continuation of the activity of the company, or the transfer thereof (in all or part).

6.13 The continuation of the company's activity (which may be combined with, for example, the cessation or transfer of one or more specific branches of its activities) must be on the basis of the clear intention and desire of the company to such end.

6.14 The transfer of all of part of the activity of the company must be preceded by bona fide offers for the acquisition thereof.

6.15 The carrying out of the plan of reorganisation must not last for longer than ten years and is assured by the judicially appointed officer (the *"commissaire à l'exécution du plan*) (who oversees the actual performance of the plan) and the administrator to whom the court grants the powers necessary for the execution of the plan.

APPENDIX B

1. Brief Overview of the Proposed Amendment of French Bankruptcy Law

Draft legislation amending French bankruptcy law has recently been presented by the Attorney General and will be discussed before the French Parliament very soon. For the moment, the draft resolution was forwarded to the French *Conseil d'Etat* on January 26, 2004. The primary modifications to French bankruptcy law contained in this draft legislation are presented below.

1.1 The *"date de cessation des paiements"*

1.2 The first proposed amendment to French bankruptcy proceedings contained in the draft legislation regards the *"date de cessation des paiements"* (*e.g.*: suspension of payments date).

1.3 Under the present rules, such date constitutes a "bright line" between conciliation proceedings and judicial proceedings. Where a company is under *cessation des paiements* - *i.e.* as of the date upon which a company is basically unable to pay its liabilities due with its liquid assets – it is required to file for bankruptcy within 15 days of the so-called *date de cessation des paiements*. Judicial proceedings will then be opened, meaning that conciliation proceedings are no longer allowed. On the contrary, where a company is not yet under *cessation des paiements*, conciliation proceedings may still be opened.

1.4 The draft legislation, if implemented, will allow a company to ask for the benefit of conciliation proceedings, even though it is already under *cessation des paiements*, provided that the *cessation des paiements* has not occurred more than a month prior to this request. Such possibility allows a company already under *cessation des paiements* to conduct out of court negotiations with its creditors in order to reach, if possible, a payment agreement with them.

1.5 The draft legislation also allows a company which is not yet under *cessation des paiement* to file for the opening of anticipated bankruptcy proceedings. Such a possibility is regarded as a viable solution in particular cases where conciliation proceedings may not be successful because of the high number of creditors or because of the apparent inability of the parties to reach some agreement among themselves as a result of conflicting interests.

2. The Promotion of Conciliation Proceedings

2.1 One of the main purposes of the proposed amendments to the current legislation regarding bankruptcy proceedings is to promote conciliation proceedings, which have shown, as of today, better results than judicial proceedings in terms of the rescue of insolvent companies, although such proceedings are less frequently used.

2.2 As previously stated, the draft legislation broadens the application of conciliation proceedings, since it allows a company which is already in *cessation des paiements* for less than a period of one month to proceed with a *redressement amiable* (*e.g.:* a conciliation proceeding) rather than to immediately file for bankruptcy. The *redressement amiable* is a new conciliation proceeding that the draft legislation proposes to substitute for the existing *réglement amiable.*

2.3 The draft legislation promotes recourse to *redressement amiable* by rendering it more attractive for creditors accepting to negotiate with the insolvent company to reach a payment agreement. In this respect, the draft legislation proposes to grant a prepayment privilege to any creditor who agrees to *"grant, in this agreement, a credit, an advance or a payment period to the debtor"*[24] during the *reglement amiable.*

2.4 However, such privilege is conditional upon the conclusion of a payment agreement between creditors and to its *homologation* (*e.g.:* formal approval) by a court. In other words, creditors are not protected during the *reglement amiable*, as well as in event of failure of the *reglement amiable*. On the contrary, where a payment agreement is reached and approved by a court, creditor's privileges will be very strong as they will prevail over almost all other claims resulting from the activity of the debtor prior to and during the *reglement amiable.* Only legal fees and employees "super privileged claims" may have priority over the claims of creditors who granted credit to the debtor during the *reglement amiable*.

2.5 It should be noted that the draft legislation does not amend the existing *mandat ad hoc*, which is a second type of conciliation proceeding, very similar to the *redressement amiable,* but much more informal.

3. Amendments Proposed to the Existing Redressement Judiciaire

In respect to judicial proceedings, the draft legislation amends many aspects of the existing *redressement judiciaire*.

3.1 Opening of the "Redressement Judiciaire"

3.1.1 First of all, as said before, the draft legislation, if implemented, will allow a company facing established or expected difficulties which are likely to lead it to *cessation des paiements* to file immediately for bankruptcy without waiting to fall into *cessation des paiements.*

3.1.2 As a result of the general relaxation of the importance of the *date de cessation des paiements* proposed by the draft legislation, it should be noted that, if the legislation is implemented, the period granted to the manager of a company in *cessation des paiements* to file for bankruptcy will be extended from 15 days to 1 month as of the date on which such *cessation des paiements* has occurred. In addition, any request for a modification of the *date de cessation des paiements* will no longer be allowed one year after the opening of bankruptcy proceedings, and the *date de cessation des paiements*

[24] Unofficial translation of proposed article L. 611-4 of the French Commercial Code.

may not be postponed to a date preceding the approval of a payment agreement reached under conciliation proceedings, except in case of fraud.

4. Duties and Powers of the *"Administrateur Judiciaire"*

4.1 With regard to the powers of the *administrateur judiciaire* (*e.g.:* the bankruptcy trustee) the draft legislation introduces a new distinction. In a case where a manager has filed for bankruptcy whilst the company was not yet under *cessation des paiements*, the role of the *administrateur judiciare* is limited to giving assistance and nursing the debtor. However, the administrator will not be allowed to substitute the managers in representing the company in its conduct of business in the ordinary course. On the contrary, if the company was already in *cessation des paiements* when bankruptcy was filed, the court is empowered to assign to the *administrateur judiciaire* the role of managing the company in place of its managers, as it is entitled to do under the current legislation.

4.2 Within two months of the *jugement d'ouverture* (*e.g.:* judgment opening bankruptcy proceedings), the *administrateur judiciaire* is required to remit to the *juge commissaire* (*e.g.:* the judge in charge of conducting the bankruptcy proceedings) a report giving its opinion on the possibility of the company continuing to finance its business. In light of this report, the court will decide whether or not to go on with the *redressement judiciare* or to immediately liquidate the company.

4.3 Condition of the Creditors

Under the proposed legislation, creditors of the company whose claims arise from the period following the *jugement d'ouverture* are still granted a prepayment privilege over creditors whose claims arise from the period preceding the *jugement d'ouverture,* is presently the case under the existing legislation. However, if the draft legislation is implemented, the enforcement of such priority privileges will be less efficient where a *reglement amiable* precedes the opening of the *redressement judiciaire*, since creditors who granted credit to the debtor under an agreement reached during the *redressement amiable* are also granted similar prepayment privileges.

4.4 Solution of the Proceedings

4.4.1 Under the current legislation, a *redressement judiciaire* may end up with the adoption of a *plan de continuation* (*e.g.:* continuation plan) or of a *plan de cession* (*e.g.:* sale of assets plan).

4.4.2 *A plan de continuation* may be adopted by the court where it appears, on the basis of the report submitted by the *administrateur judiciaire*, that there exist serious possibilities for the recovery of the company and for the payment of its liabilities (by adopting measures such as delays of payment, restructurings, *etc.*)

4.4.3 *A plan de cession* may be adopted by the court where it appears that a company is not viable in its actual structure, and that possibility of recovery is conditional upon the sale of different activities or business units.

4.4.4 Finally, a *redressement judiciaire* may be converted at any moment into a *liquidation judiciaire* (*e.g.:* judicial liquidation) where it appears to the court that the recovery of the company is no longer possible. Since 1994, a *liquidation judiciaire* may also be opened from the very beginning of bankruptcy proceedings, on the date of the *jugement d'ouverture*, when it is obvious that the company has no chance, of recovery.

4.4.5 The primary change contained in the proposed draft legislation is *that redressement judiciaire* may only result in a *plan de redressement*. If the draft legislation is implemented, the *plan de cession* will no longer be a possible outcome of a *redressement judiciaire*, but a way to proceed with the judicial liquidation of the company. Therefore, if a *plan de continuation* is not adopted by the court, the court will be bound to proceed with a judicial liquidation of the company.

5. Amendments Proposed to the Existing Liquidation Judiciaire

5.1 The draft legislation also proposes to create a second type of *liquidation judiciaire*, which will be called *liquidation judiciaire simplifiée,* applicable to a company whose possibilities of recovery are non-existent in that:

(a) the company has no real estate assets, and

(b) its number of employees and its annual turnover do not exceed a threshold defined by a decree to be implemented.

5.2 The second modification applies to both types of liquidations and makes the *plan de cession* a way to liquidate the company. In the case of the total or partial sale of assets of a company, the draft legislation provides that a court may appoint an *administrateur judicaire*, who will be in charge of preparing the *plan de cession,* while the liquidator will manage the company during the operation of liquidation.

5.3 Should the draft legislation be implemented, in the context of a *plan de cession,* a forced sale of the company's contracts would become a possibility, which is presently not the case under the current legislation.

5.4 It should also be noted that the draft legislation proposes to grant the debtor a right of appeal from a decision approving the *plan de cession*, which is not allowed under the current legislation, whereas the right of appeal of the public prosecutor will be deprived of its suspensive effect.

5.5 Finally, under the current legislation, lawsuits against a debtor are prohibited once liquidation operations are closed for insufficiency of assets *(clôture pour insuffisance d'actif)*, except in a very limited number of cases. The draft legislation proposes to introduce new cases in which creditors will recover their right to sue the debtor, including:

(a) the existence of a former criminal condemnation of the debtor, whatever the grounds for such condemnation;

(b) the existence of former bankruptcy proceedings also closed for insufficiency of assets against managers of the debtor.

6. Sanctions Against the Debtor

6.1 One of the major changes proposed by the draft legislation is the removal of the automatic extension of bankruptcy to shareholders indefinitely responsible for liabilities of the company.

6.2 The draft legislation further proposes to change the general statute of limitation for all personal sanctions applicable to the debtor or its managers under French bankruptcy law to 5 years from the opening of the proceedings.

6.3 Finally, new sanctions would be applicable to the debtor who, by refusing to cooperate with the bodies of the proceedings, has purposely delayed or blocked the proceedings, or has made documents disappear, or presented accounts which were purposely incomplete or false.

GERMANY

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Introduction

The concept of personal, civil and criminal liability concerning the directors of German corporations (like a company with limited liability "*GmbH*" or a stock corporation "AG") is based upon the limited liability of German corporations vis-à-vis its creditors. In the absence of personal liable partners, German corporations are not only limited in terms of personal liability of the shareholders but also in terms of the assets available in the company for distribution to the creditors. Consequently, German corporate law provides for several rules relating to the contribution and the subsequent maintenance of the capital in German corporations. Furthermore, the directors are confronted with even more stringent duties, responsibilities and liabilities once the assets of the company deteriorate, i.e. should the company encounter financial difficulties. The access to information by the creditors with respect to the financial situation of the company is restricted. This corresponds with the director's duty to be completely aware of the financial situation of the corporation at any time. Thus, any liability arising during the "Twilight Zone" is mainly imposed on the directors of the corporation, who are the only so-called legal representatives of the corporation. The monitoring duties of directors are less intensive if the distressed company is not a corporation but a partnership consisting of at least one personally liable partner. In this event any duties, responsibilities or liabilities outlined in this Memorandum only apply to a limited extent unless the personally liable shareholder or partner is a company which itself has limited liability.

The German Federal court has no sympathy for directors lacking knowledge of the company's financial situation not heeding any warning signs concerning the company's deteriorating financial situation. Thus, the essential duties in the "Twilight Period" are applicable to any directors, irrespective of whether they (i) reside abroad, (ii) have an engineering instead of a commercial background, or (iii) act as a chairman of the supervisory board rather than as a manager of the ordinary daily business. This "ideal world" approach indicates the stringent duties imposed on directors during the "Twilight Period". Generally, difficulties of the company do not constitute any liabilities for the shareholders or supervisory board members vis-à-vis third parties. Shareholders or supervisory board members are not even entitled to act on behalf of the company (unless they are directors of the company at the same time). In addition to the appointed and registered directors, German corporate law does not recognise the concept of non-executive directorship, so that generally all appointed directors face the same degree of liability.

1.2 “Illiquidity”, “deficit balance” and “over-indebtedness” as key indicators for the “twilight period”

The start and duration of the Twilight Period does not depend on whether a formal insolvency procedure is instituted. Contrary to other European laws, e.g. the laws of the United Kingdom, which rather vaguely refers to points where a director “knew or ought to have concluded that insolvent liquidation is inescapable”, German courts and literature have established explicit methods according to which prerequisites indicating the start of the “Twilight Period” will be determined, such prerequisites being illiquidity (i.e. negative cash flow test), impending illiquidity, deficit balance and over-indebtedness (i.e. negative balance sheet or equity test). These key indicators trigger various duties and responsibilities of directors under German corporation, commercial and criminal law, which are also very specific unlike the purpose, e.g. of a “wrongful trading” concept designed to ensure that “directors do everything possible to minimise the potential loss to creditors in anticipation of a insolvent liquidation”.

Illiquidity and over-indebtedness are regarded as “absolute bankruptcy reasons” resulting in a duty for the directors to petition for the commencement of insolvency proceedings, while impending illiquidity grants only an option to do this.

Since illiquidity and over-indebtedness are so-called “indefinite legal terms”, regulators, courts and German literature have endeavoured to find a precise definition which will determine the start and end of the “Twilight Period”.

1.3 Determination of the twilight period

1.3.1 Illiquidity

The German Insolvency Code stipulates that a debtor is illiquid if he is unable to honour payment obligations when due. Illiquidity will generally be deemed in the event that the debtor has ceased to make payments. The German Federal Court refers to specific circumstances which apparently reveal that the company has ceased to make payments, such as

- declaration of the director of the inability to honour future obligations,
- closing of the business,
- non-payment of significant operating costs, such as wage related costs,
- execution of claims against the company

These warning signs can easily be realised by the directors, so that the requirements concerning their duty to initiate recovery actions are even stronger than in the event of a probable hidden over-indebtedness (see below).

1.3.2 Impending illiquidity

Impending illiquidity will be deemed as existent if a company is presumed to be unable to honour existing payment obligations when they become due. Contrary to the already existing illiquidity and over-indebtedness, impending illiquidity does not constitute an absolute duty of the directors to petition for the commencement of insolvency proceedings. German insolvency law has introduced impending illiquidity as an option for the petition for insolvency proceedings in order to enable the directors to initiate reorganisation measures, in particular the implementation of a pre-packaged reorganisation plan at an early stage of the insolvency proceedings. Such petition might be combined with a motion for a self-management order which derives from the concept of a “debtor in possession”. According to experience with the former German Bankruptcy Code, corporate recovery measures have frequently been interfered with by creditors executing claims by seizing the assets of the estate required to maintain and continue with the business. Following the filing of a petition for the commencement of insolvency proceedings, based on impending illiquidity, protective orders by the court may enjoin any acts of execution on the debtor’s assets. However, until now German insolvency courts are rather reluctant to order self-management due to the lack of reliability of those directors who initially may have caused the financial crisis of the company by mismanagement.

With respect to criminal liability, impending illiquidity in addition to already existing illiquidity and over-indebtedness is a constituent element of criminal offences pertaining to insolvency in the German Criminal Code and, therefore, indicates the start of the “Twilight Period” from a criminal law perspective.

1.3.3 Over-indebtedness

While already a deficit balance (i.e. the assets available in a company are less than the registered share capital), to the extent that half of the registered share capital is lost, constitutes the duty of directors to convene a Shareholders’ Meeting, the over-indebtedness of a company is an absolute reason for an immediate petition for insolvency proceedings.

This over-indebtedness is not reflected in the ordinary year-end balance sheet, but it may result from a special “over-indebtedness status”. Generally, the directors are obliged to carefully monitor the financial situation and institute control devices such as the preparation of monthly interim balance sheets as soon as certain warning signs that the company is experiencing financial difficulties have been revealed, e.g. a significant loss of share capital.

In the event that a (interim) balance sheet shows a technical over-indebtedness the directors have to prepare an “over-indebtedness status” in order to verify whether or not the company is actually over-indebted. In this “status” the assets in the first round would have to be evaluated according to liquidation values. Provided there is a “positive continuation prognosis”, the directors may evaluate the assets according to a “going concern”. The positive continuation prognosis requires that a detailed and clear medium-term business plan shows that, in operative business and financial matters, the company can survive and prosper in such a way that during this period an insolvency of the company does not occur. Furthermore, it is not sufficient that the directors accept the prognosis as being correct and the results of the planning as “most probable”. German courts have always held that the managers must seek the advice of independent outside experts with respect to such a prognosis. These experts must be convinced to the same degree as the management that a positive continuation prognosis exists. In the event that an “over-indebtedness status” which has been drawn up with going concern values still shows a negative equity, the company has to be regarded as being actually over-indebted and this actual over-indebtedness will constitute the duty to an immediate petition for insolvency proceedings.

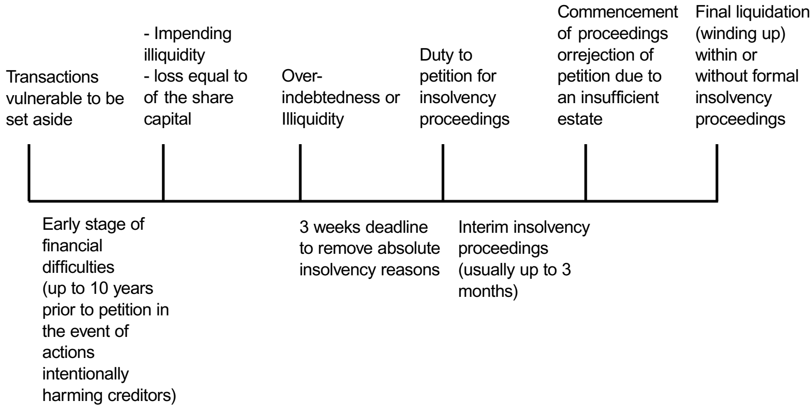
1.3.4 End of the twilight period

As a result of the commencement of insolvency proceedings the directors’ right to manage and transfer assets of the company will pass to the insolvency administrator. Although the directors will still be registered with the commercial register, the power to act on behalf of the company has practically ceased to exist. Thus, the directors can no longer be held liable for a violation of rules aiming at the protection of creditors.

In the event that the petition for the commencement of insolvency proceedings will be rejected because the assets available in the estate would not be sufficient to cover the costs of the insolvency proceedings, the insolvency court will terminate any protective measures ordered so far, including any restrictions on the directors to dispose of the assets. Consequently, the directors will regain control of the company. Since the order rejecting the commencement of insolvency proceedings leads to the dissolution of the company, the directors are now the “born” liquidators who will wind up the company without formal insolvency proceedings. This so-called “lack of assets liquidation” will not be governed by specific rules in addition to the rules pertaining to the “ordinary” voluntary liquidation of companies, which are based on the assumption that the assets would be sufficient to satisfy all creditors. Since the German Insolvency Code, namely the statutes which ensure the equal treatment of creditors of the same rank, are not applicable outside formal insolvency proceedings (according to the prevailing court rulings), there are controversial discussions in German literature as to whether the directors are bound by the principles of the equal treatment of creditors although formal insolvency proceedings involving all creditors have not been instituted by the insolvency court. In practise, the termination of protective measures ordered by the court at the time of the commencement of interim insolvency proceedings, namely the prohibition of execution on the debtors’ assets, will result in a resumption of the temporarily restrained execution acts by the respective creditors impeding a proportional distribution of the assets to all creditors according to the principles of equal treatment. Given that the aforementioned deficiencies have been addressed in the reasoning of the bill, leading to the recent replacement of the existing Bankruptcy Code by the new Insolvency Code, any amendments of the statutes pertaining to the liquidation of impecunious companies seem to be unlikely, although a satisfactory solution could not be achieved so far.

1.4 Summary

The following diagram endeavours to illustrate the start and duration of the Twilight Period in terms of civil and criminal liabilities of directors and voidability of actions (see Question 4 below).



QUESTION 2

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2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the “twilight” period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

2.1 Criminal and civil liability

The German Civil Code provides that any person who violates a statute intended for the protection of others (so-called “protection statutes”) is bound to compensate the injured party for any damage arising therefrom. Any criminal statute aiming at the protection of property is deemed as such protection statute, namely statutes which provide for the protection of the creditors of a distressed company attaches personal liability to directors who are obligated to compensate losses resulting from a violation of such protection statutes. The following duties directed solely against directors of a distressed company and resulting in criminal as well as civil liability can be found in German Corporate law and German Criminal Code, a summary of each will be considered in turn.

2.1.1 Duty to convene a shareholders’ meeting

Pursuant to the German Companies with Limited Liability Act and the German Stock Corporation Act, directors have the duty to convene a shareholders’ meeting in the event that, upon preparation of an annual or interim balance sheet, it becomes apparent or it must be assumed by reasonable belief that the company has incurred a loss equal to one-half of the share capital. An action may be brought by the company seeking compensation for damages which could have been avoided by resolution or measures which would have been adopted by a shareholder’s meeting if such meeting has been convened in due time.

2.1.2 Duty to petition for the commencement of insolvency proceedings

In practice, the most important event of the civil and criminal liability of directors results from a failure to timely petition for the commencement of insolvency proceedings. Directors of a German company with limited liability, a German stock corporation and a German partnership which consists only of companies with limited liability have the absolute duty to petition for the commencement of insolvency proceedings without undue delay, however, not later than three weeks after the occurrence of illiquidity or over-indebtedness (see above for details as to determination of illiquidity or over-indebtedness). In addition to criminal sanctions, the directors face a civil liability to compensate the company as well as the creditors of the company who suffer a loss caused by the failure of the directors to file the petition in due time.

2.1.2.1 Liability vis-à-vis the company

The Corporate law provisions create a duty of directors to compensate the company for any payments made after the illiquidity has occurred or the over-indebtedness was discovered. This does not apply to payments which were consistent with the due care of a prudent businessman.

2.1.2.2 Liability vis-à-vis the creditors

The German Federal Court has established and recently amended a rather complex method to ascertain the loss suffered by the respective creditor. In calculating the damage compensation, one has to distinguish between creditors already having claims against the company at the time the petition had to be filed, respectively the company which was to become subject to insolvency proceedings (so-called “old creditors”), and creditors who have entered into business relations with the company after that time (so-called “new creditors”).

Assuming that the directors would have filed the petition in due time the "old creditors" would have received a pro-rata distribution based on the assets available at such time. Thus, the total loss suffered by the old creditors has to be calculated by way of a comparison between the assets actually available in the insolvency estate and the assets which would form part of the estate if the directors would have filed the petition in due time. Since the "new creditors" would have refrained from entering into business relations with a company already subject to insolvency proceedings, their loss encompasses the general interest in the agreement. Such loss is probably significantly higher than the loss suffered by the old creditors.

In addition, the German Insolvency Act enables an action to be brought by any person who has made an advance payment in order to avoid that the petition for the commencement for insolvency proceedings will be denied by reason of insufficient assets available in the insolvency estate. The damage compensation comprises the reimbursement of any advanced payments.

2.1.3 Liability vis-à-vis social security authorities

The German Criminal Code imposes sanctions on directors who intentionally fail to transfer social security contributions of employees to the social security authorities. The predecessor statute in the German Criminal Code expressly set out that directors would only become liable in the event that they fail to transfer social security contributions which have been actually deducted and withheld from wages. Literally, the new statute does no longer require such deduction and withholding. Although, some higher regional courts argued that directors could not be held liable for a failure to transfer social contributions despite wages not having been paid to the employees. According to these court rulings something similar to a criminal breach of trust is required which could only be deemed in the event that social contributions will not be transferred despite the corresponding wages having been paid.

The German Federal Court reversed one of the aforementioned judgments referring explicitly to the wording of the statute. With this ruling the German Federal Court increased the directors' responsibilities vis-à-vis social security authorities significantly. A conflict of duties may arise if directors are obliged to transfer social security contributions while they may incur personal liability if they initiate any payment following illiquidity and/or overindebtedness (see 1.2). However, the German Federal Court recently lifted such payment duty for the three week filing period (see 2.2.2). Directors who do not transfer social security payments within this period do not incur a penalty.

Notwithstanding, a criminal offence will only be deemed in the event that directors fail to transfer the contributions despite funds being available or fail to arrange for safety precautions for the payment of employees' contributions when indications of illiquidity appear and tacitly accept that the contributions cannot be transferred subsequently. The German Criminal Code cannot impose sanctions in the event that the transfer of the social security contribution was impossible due to absolute illiquidity.

With respect to civil liability, the director is obligated to compensate any damages due to the failure to transfer the social contributions which practically results in an obligation to pay compensation in the amount of the social contributions not transferred.

2.1.4 Fraud

Criminal and civil liability due to trading fraudulently will attach to directors who incur further credit by way of entering into agreements with suppliers or lenders in the Twilight Period pretending that the company is solvent. Furthermore, long-term agreements during the course of which up-front payments by the purchaser are customary have to be carefully considered by the directors if they are aware of an impending insolvency situation at the time of the conclusion of the agreement and therefore anticipate insolvency proceedings in the near future. Civil liability of directors will be deemed by the German Federal Court in the event that a supplier has been induced by directors to render advance performance without directors having any prospects of being able to pay the consideration.

2.1.5 Crimes pertaining to insolvency

Crimes pertaining to insolvency, if governed in the German Criminal Code, explicitly refer to the "Twilight Period" starting already with impending illiquidity. Alternatively, such criminal statutes apply in the event of an actual over-indebtedness situation of the company, as set forth above. Generally, such crimes relate to conduct which endangers the creditors' rights. Crimes frequently committed in the period of the Twilight Zone by directors who desperately try to cope with the financial situation and seek to preserve the business by avoiding formal insolvency proceedings, comprise

- destruction of or damage to assets in a commercially irresponsible manner,
- entering into speculative transactions,
- simulation of the existence of assets,
- violation of the duty to keep books and other statutes of commercial law relating to the accurate disclosure of the current financial situation and the prospect of the business in the books, in particular the balance sheet and the management report,
- endangering the rights of creditors on whose behalf the company holds assets on trust,
- preferential treatment of creditors by way of granting them security or satisfaction to which they are not entitled, and thereby acting intentionally to the detriment of other creditors.

2.2 Civil liability

2.2.1 Liability arising from the causation of an insolvency situation

Generally, directors have to apply the "due care of a prudent businessman" when transacting company affairs. According to German literature, these principles will be violated in the "Twilight Period" in the event that the directors fail to respond immediately to a financial crisis by way of initiating corporate recovery measures. However, since such obligations are not precise, a claim to compensation by creditors can hardly be based on such omission.

2.2.2 Breach of agreement / acting as guarantor vis-à-vis counter-parties

A German Federal Court ruling attaching liability to the directors of a construction company is the subject of a controversial discussion as to whether or not the directors can be held liable for obligations to be fulfilled by the company. The director's liability in the prevailing matter was based on the position of being a guarantor with respect to obligations imposed on the company in connection with an agreement on the provision of collateral to a supplier. The director was made personally liable because he failed to ensure that the security provided by the company could finally be realised by the creditor. As far as the exploitation of personal trust of the directors is concerned, court rulings generally require an additional personal warranty from the director to the effect that his declarations are correct. In this event, the third party relies on the reputation of the director rather than on the reputation of the represented company.

2.2.3 Group liability / piercing the corporate veil

Assuming the director is also a dominating shareholder of the company, the concept of group liability might result in an obligation of the controlling shareholder to compensate any annual net loss due to the misuse of its managerial power. The German Federal Court explicitly stated that the concept of "group liability" is also applicable in the event that the shareholder is a natural person and not a legal entity, e.g. the director of the company. The precedent concerned a German company with limited liability having only one shareholder who simultaneously managed the business as the sole director. The court held that the shareholder had misused the concept of limited liability because he actually conducted the business as a sole trader pursuing only his personal interests while intentionally neglecting the affairs of the company. Therefore, the natural person had to be regarded as a "dominating company" analogously to the concept of liability in a group consisting of corporations.

However, the German Federal Court recently changed previous jurisprudence, reverting to piercing the corporate veil due to an objective misuse of the concept of limited liability. The court held that the liability of the controlling shareholder is not based on the conduct of a 'company shareholder' but on the intentional 'damnification' of the company's self interest, which has to result in the loss of the privilege limited liability. The German Federal court has not created a new liability but rather given a new name to the old piercing of the corporate veil. As this misuse is identified by the damnification of the company's ability to meet their obligations it has been named the 'liability due to the annihilation of existence' *(Existenzvernichtung)* or due to the so-called 'existence-annihilating interference' *(existenzvernichtender Eingriff)*.

2.2.4 Violation of capital maintenance rules

The capital maintenance rules of the German Companies with Limited Liability Act aim at the preservation of the assets required to maintain the registered share capital and such assets may not be distributed to the shareholders. Any distribution of assets to shareholders during the "Twilight Period" will most likely constitute such redemption of share capital. The directors of the company are personally liable vis-à-vis the company to the extent that assets have been distributed to shareholders in violation of such capital maintenance rules.

2.3 Liability vis-à-vis tax authorities

2.3.1 Obligation to transfer deducted wage taxes

The directors are obligated to deduct wage taxes from the gross amount of wages and to subsequently transfer the deductions to the tax authorities. Since tax deductions from wages are regarded as money held on trust to the benefit of the tax authorities, the failure to transfer such money leads to a personal liability of the directors. In the event that the cash flow is not sufficient to pay the gross amount of wages, the directors are obligated to reduce wage payments to the extent that the wage taxes calculated on the basis of the reduced gross amount of wages can be paid to the tax authorities.

2.3.2 Preference of other creditors

Generally, the company creditors must be treated equally by the directors during the Twilight Period. With respect to outstanding taxes, the directors are personally liable to the extent that other creditors have been preferred to the detriment of the tax authorities. In the “Twilight Period”, directors are required to satisfy the claims of the creditors equally on a pro rata basis in the event that the funds are not sufficient to completely satisfy all creditors.

2.4 Liability in proportion to specific involvement

The rules of procedure, respective service contracts or any oral agreement frequently provide that directors with an engineering background are primarily responsible for technical matters while financial matters are mainly covered by economists. Therefore, the engineering-related directors are probably not completely aware of the current financial situation of the company. In spite of this, German corporate, commercial or criminal law which govern the specific duties, responsibilities and liabilities of directors, neither expressly attach liability pro rata their specific involvement, nor allocate liability to a specific sphere of responsibilities or areas of practice. Moreover, directors are also responsible for another director’s violation of duties, so that practically each director has to use due diligence not only in his own affairs but has to ensure that the other directors will also meet the requirements to the same degree.

However, these principles are not constantly applied, so that a defence like the allocation of spheres of responsibilities to other directors might be available. In particular, the German Criminal Code requires intentional conduct unless expressly negligent conduct is subject to criminal sanctions. Generally, intentional conduct can only be allocated to directors who actually fail to comply with the respective duty. In addition, intentional conduct might be deemed in the event that other directors of the managing board are completely aware of the omission of the other responsible director. Furthermore, court rulings have imposed a supervision duty on the other directors with respect to the compliance of the director actually in charge with the relevant financial matters.

The following outlines whether liability will be attached according to the violation of specific duties by the respective director or whether any director of the management board will face liability irrespective of his involvement.

Actions giving rise to liability	Liability of management board members
Duty to convene a shareholders' meeting	Joint liability
Duty to petition for the commencement of insolvency proceedings	Joint liability
Liability vis-à-vis social security authorities	Liability is allocated to directors who actually fail to transfer the social security to contributions or who were completely aware of the omission of the other responsible director
Fraud /crimes pertaining to insolvency	Liability is allocated to directors who actually commit the crime or who have been completely aware of the crime
Liability arising from the causation of insolvency proceedings	Joint liability
Breach of agreement	Joint liability
Piercing of corporate veil	Directors who are shareholders as well
Violation of capital maintenance rules	Joint liability; at least negligence of each director required
Liability vis-à-vis tax authorities	Liability is allocated to directors who actually fail to transfer the taxes provided that (i) the allocation of duties was to be made in written form and was to be clear cut (ii) the responsible director is reliable (iii) other directors properly supervised responsible director

2.5 Defences

2.5.1 Transactions to the benefit of the company

Defences regarding any reasonable belief of a director that a transaction is to the benefit of the company are only available if the statutes establishing the liability have a subjective element. This applies to some statutes in the Insolvency Act governing the voidability of transactions (see below). Furthermore, that belief might exclude the assumption of intentional behaviour as required in the Criminal Code. As far as statutes intend to protect specific counter-parties, i.e. as public authorities or creditors dealing with an already illiquid company, that defence is not available.

2.5.2 Actual involvement

As set out above, directors, irrespective of their actual involvement in financial matters and their sphere of responsibilities, have to be generally aware of the company's current financial situation, at any time. The German Federal Court held that the defence as to a lack of knowledge of the company's insolvency situation would only be available if such lack of knowledge is not caused by the directors' negligence in exercising their observation duties and instituting financial control systems.

2.5.3 Return to solvency

The financial crisis of any distressed company needs not be constant but may be temporary. Any duties and responsibilities are related to an insolvency situation, so that solvency at the time of the transaction, cannot result in a liability of directors unless impending illiquidity had to be assumed. Generally, solvency after the transaction does not remedy the violation of duties. In the event of the return to a sustainable financial recovery enabling the company to fully satisfy any claims of creditors, it is unlikely that any criminal prosecution or civil actions based on an past insolvency situation will be commenced. One exemption will be made with respect to a violation of capital maintenance rules. The German Federal court recently held that the crucial point of time is when assets will be distributed to the company shareholder, so that the return to solvency will not cure the violation and any pertinent liability. Similarly, criminal prosecution may even be initiated in the event that creditors did not actually suffer any losses because most of the crimes pertaining to insolvency will be regarded as "abstract strict-liability torts".

QUESTION 3

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3. Other persons involved with the company's affairs that may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Civil and criminal liability of accomplices and participants

As a general rule, liability of other persons involved with distressed companies can be based upon violations of statutes of German law as set forth above provided that they have to be regarded as accomplices or participants of the violation. German civil law imposes a joint and several liability on persons who are jointly liable for damages irrespective of their degree of involvement while German criminal law allows reducing the punishment of an aider and abettor. In addition German civil law provides for a joint and several liability even if it cannot be discovered which of several participants has caused the damage through his action. This leads to a shift of the burden of proof to the persons who have caused the damage.

3.2 Other parties liable for the management of distressed companies

3.2.1 De facto directors

The position of a director is clearly defined in German Corporate law setting forth that directors are individuals who were appointed by a Shareholders' Resolution (in the case of a company with limited liability) or a Supervisory Board Resolution (in the case of a stock corporation). Although it is only of a declaratory nature, the directors are obligated to subsequently file their appointment for registration with the commercial register of the competent local court. Contrary to directors who are duly appointed and registered, de facto directors may actually govern and control the management of the company and, therefore, might be deemed to be acting in a directorial capacity. The German Federal Court rather declines to regard any person (partially) involved in the management of the company as a de facto director given that the company will still be managed by the duly appointed and registered director. Moreover, not even management to the same extent and degree as exercised by the registered director would constitute a de facto directorship. The German Federal Court requires that the de facto director (i) is the sole person who conducts the business of the company, or (ii) is in a position to instruct the registered shareholder, or (iii) conducts the business more extensively than the registered director and, therefore, has to be regarded as the "sole" director of the business.

3.2.2 Former directors

Certainly, the directors' liability is based on any conduct exercised during the period of their directorship, so that even former directors will face liabilities regarding their directorship at the time the company was subject to insolvency proceedings. In addition to a potential liability, the German Insolvency Code sets out that former directors who have resigned or otherwise left the position of a director not earlier than two years prior to the commencement of insolvency proceedings, have the same duties of information and co-operation with the insolvency administrator as persons who are still in the position of a director at the time of the insolvency proceedings.

3.2.3 Supervisory board members

In addition to the Management Board members, Supervisory Board members frequently conduct the company's affairs during the Twilight Period.

"Dominating" Supervisory Board members who tend to have a material influence on the company management, e.g. by way of exercising typical management duties, run the risk of being regarded as de facto directors according to the principles set forth above.

Furthermore, Supervisory Board members might face a liability vis-à-vis the company in the event that they fail to exercise the due care of a prudent businessman during the Twilight Period. Supervisory Board members are also liable in case of a participation in the delay to petition for the commencement of insolvency proceedings. In this respect, the following cases are regarded as a breach of duties:

- initiating, respectively tacit toleration, of a deterioration of assets
- non-compliance with more stringent supervising requirements in case of a financial crisis of a GmbH
- failure to seek advice by independent experts
- failure to instruct and to urge the managing directors to petition for the commencement of insolvency proceedings in case of an insolvency situation

3.2.4 Creditors / financing banks

Two key issues continually arise when considering unconnected third party risks providing additional credit during the Twilight Period. Firstly, how safe is it for an unconnected third party in terms of criminal liability to encourage directors to continue with the business despite an insolvency situation by way of providing further (short-term) credit, thereby enabling the directors to meet the most urgent payment duties? Secondly, can an unconnected third party rely on the validity of securities provided by the distressed company in order to secure loans granted during the "Twilight Period"?

There is controversial discussion as to whether or not the granting of loans at the time when the company was to become subject to a formal insolvency proceeding, might encourage the directors not to comply with their duty to petition for the commencement of insolvency proceedings. This might be regarded as a participation of the lender in the crime of a delay to petition for bankruptcy proceedings committed by the directors.

With respect to civil liability of the lender, it has to be evaluated whether the granting of a loan secured by the transfer of assets of the distressed company to the lender finally resulted in a deterioration of the assets of the distressed company compared to the assets available in the insolvency estate in the event that a petition for the commencement of insolvency proceedings would have been filed at the time of granting the loan.

The voidability of a transfer of assets of the distressed company for security purposes will also be discussed in connection with lending strategies of banks. In particular, in the event of so-called bulk securities, such as the assignment of trade receivables of the distressed company, it might be more reasonable from a commercial perspective of the lender to grant further loans or prolong existing loans in order to enhance the value of the assigned trade receivables rather than to cease funding the borrower, which results in an deterioration of assigned trade receivables, because of counter-claims filed by the customers due to the impact of the commencement of insolvency proceedings and the termination of the business of the distressed company.

Thus the granting of a loan to a distressed company is connected with several risks to third parties. In order to minimise these risks the third party needs to be reasonably confident that the company is able to overcome the crisis with its help before granting a restructuring credit (*Sanierungskredit*). Therefore the prospects of a successful restructuring need to be examined carefully. The basis of the decision to lend will be a restructuring plan (*Sanierungsplan*) prepared by the management of the debtor which reflects the reasons for the existing crisis and the measures to be implemented to overcome the crisis. In particular, an audit of the restructuring plan has to reach the conclusion that there is a going concern, i.e. a positive continuation prognosis (*positive Fortführunsprognose*) for the company's business at least up to the end of the following fiscal year.

So far, such granting or prolongation of loans to distressed companies in the "Twilight Period" have not been subject to criminal prosecution, but rather subject to an action to set aside by the insolvency administrator, with respect to the assets transferred by the distressed company to the lender, in order to secure the loan. The granting of security during the Twilight Period by a distressed company to a lender might be set aside subsequently by the insolvency administrator, because the lender had "no right to claim security in such manner or at such time" (so-called "incongruent correspondence"). The time period in which the transaction has to be effected prior to the petition for insolvency proceedings will be extended in the event that the creditor had knowledge at the time the security was granted that it was detrimental to the insolvency creditors. Generally, granting of security in proximity to the subsequent petition for insolvency proceedings implies an action to the detriment of the insolvency creditors, unless the granting of security is part of a reorganisation plan involving such creditor. However, if security will be granted in consideration for "fresh money" by the bank, such action is generally not to the detriment of the creditors and, therefore, cannot subsequently be set aside by an insolvency administrator.

QUESTION 4

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4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Transactions potentially subject to an action to set aside

4.1.1 General rule / heads of challenge

Transactions to the detriment of insolvency creditors effected prior to the commencement of insolvency proceedings might be subject to an action to set aside. Transactions will be deemed as detrimental in the event that either the liabilities of the debtor in insolvency proceedings have been increased or the assets available in the insolvency estate have been reduced.

The legal term “transactions” encompasses all acts which either gave or made it possible for a counter-party dealing with the distressed company to receive security or satisfaction. The German Insolvency Code distinguishes between

(i) congruent correspondence,
(ii) incongruent correspondence,
(iii) directly detrimental transactions,
(iv) intentionally harmful actions,
(v) performance without consideration
(vi) redemption of loans in lieu of capital contributions

as potential heads of challenge. For each transaction a different time limit in respect of voidability is applicable. The time limits cover transactions which are effected in the month prior to the petition for commencement, as well as transactions which are effected after such petition (in the event of merely incongruent correspondence) up to transactions effected ten years prior to the petition for commencement (in the event of intentionally harmful actions).

From the point of view of a counter-party dealing with the company during the Twilight Period, it is decisive whether;

(i) the counter-party had knowledge of the illiquidity of the company at the time of the transaction,
(ii) the creditor had knowledge of the petition for commencement of insolvency proceedings at the time of the transaction,
(iii) the creditor had equivalent knowledge on circumstances which compel the conclusion with respect to the illiquidity or the petition for commencement of insolvency proceedings,
(iv) the counter-parties are persons related to the distressed company and, therefore, will be deemed as having such knowledge,
(v) the counter-party had knowledge of circumstances which compel the conclusion that the transaction was detrimental to the insolvency creditors,
(vii) the counter-party had knowledge of the intent of the distressed company to harm its creditors, such knowledge will be presumed if the counter-party had knowledge of an impending illiquidity and of the fact that the transaction was harmful to creditors, and
(viii) the counter-party received any performance without payment or any other consideration.

4.1.2 Voidability of transactions outside of insolvency proceedings

Any of the creditor protection measures outlined above are applicable accordingly, even if formal insolvency proceedings will not be commenced following the Twilight Period. Such voidability of transactions is governed in separate statutes, i.e. the Avoidance Act *("Anfechtungsgesetz")*. The claims to avoidance have to be filed by a creditor and not by an insolvency administrator. In the event that execution in the assets of the debtor will not lead to complete satisfaction of the creditor, or it has to be assumed that any execution will not be successful, the creditor is entitled to file an action to set aside. Certainly, the time period in which an action might be attacked also cannot refer to the petition for the commencement of insolvency proceedings. Therefore, it is decisive, whether the transaction has to be exercised by a creditor with the competent court within a specific time period prior to the filing of an action to set aside.

4.2. Defences

Benefit to the company ensuing from the transaction

A defence, such as the assumption of the parties that the transaction would be to the benefit of the company is only permissible if such transaction was also to the benefit of the insolvency creditors. In determining whether or not any transaction was to the benefit of the insolvency creditors, only the assets in the insolvency estate available for distribution to the creditors will be considered. If any transaction exercised in the "Twilight Period" resulted in the granting of security of satisfaction to a creditor who could not claim security or satisfaction at that time (since he was merely an ordinary or even subordinate insolvency creditor), such transaction will not be to the benefit of the insolvency creditors in subsequent insolvency proceedings.

4.2.2 Lack of knowledge of the company's insolvency position

As far as any transaction requires,

(i) knowledge of the illiquidity situation, or
(ii) knowledge of any circumstances that compel the conclusion as to the illiquidity situation, or
(iii) the creditor had knowledge that the transaction was detrimental to the insolvency creditors, or the knowledge of circumstances that compel the conclusion in this respect any lack of knowledge of the current financial situation of the company by the creditor has to be regarded as a permissible defence.

4.2.3 Solvency of the company at the time of or after the transaction

Since any action exercised prior to the commencement of insolvency proceedings might be subject to an action to satisfy, the German Insolvency Code does not refer to an insolvency situation at the time of or after the transaction, but refers to a specific time period which leads to the conclusion that the company is in the Twilight Period, irrespective of whether or not the company was solvent at the exact time when the transaction was actually exercised.

4.2.4 Other defences

Transactions by the debtor with the intent of harming its creditors can be attacked within the last ten years prior to the petition for commencement of insolvency proceedings. Therefore, a lack of intention to prefer a creditor has to be regarded as a permissible defence in this respect. However, since the German Insolvency Code does not require any intention to prefer creditors with respect to the remaining potential heads of challenge, but rather considers mere knowledge of the illiquidity situation of a company by the creditor who benefits from the transaction as sufficient, the defence of a lack of intention to prefer is limited.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Creditors / shareholders / public authorities / other third parties

Civil actions against directors will generally be brought by parties suffering damages due to a violation of duties irrespective of whether they are suppliers, lenders, shareholders or any other third party dealing with the company. In addition, tax authorities and social security authorities will file claims arising from the failure of the directors to transfer taxes and social security contributions.

Shareholders liable to make contributions to the insolvency estate can hardly claim compensation from the directors since their civil liability is normally based upon (i) a violation of capital maintenance rules by way of a prohibited redemption of contributions, or (ii) a misuse of managerial power in favour of the controlling shareholder. Consequently, the shareholders are only liable in the amount of the received payments they have not been entitled to.

5.2 Insolvency administrator as office holder for the insolvency estate

5.2.1 Joint damages of creditors

Upon the commencement of formal insolvency proceedings, the German Insolvency Code states that claims for damages by insolvency creditors who have suffered by such creditors jointly and severally as a result of the reduction of the insolvency estate (joint damages) may be claimed only by the insolvency administrator during the insolvency proceedings. As outlined above (see C.I.2), in the event of a delay of the petition for commencement of insolvency proceedings such joint damages will be suffered by the so-called “old creditors” since the diminution of the insolvency estate will lead to a reduction of the pro rata distribution following the realisation of the assets of the insolvency estate. In contrast, the so-called “new creditors” do not suffer joint damages due to a reduction of the insolvency estate, but have claims to the negative interest resulting from the respective agreement. Consequently, according to prevailing opinions in legal literature, such individual damages have to be assessed according to the respective agreement and, therefore, can only be claimed by the respective creditor.

5.2.2 Enforcement of claims in his capacity as office holder for the company

Upon the commencement of the insolvency proceedings, only the appointed insolvency administrator is entitled to represent and act on behalf of the company. Therefore, claims of the company, irrespective of whether or not they already existed at the time of the commencement of the insolvency proceedings (even before the start of the Twilight Period), or will arise following the commencement of the insolvency proceedings in the course of the continuation of the company's business, can only be enforced by the insolvency administrator. Further, only the insolvency administrator is entitled to void transactions by an action to set aside, claiming the return of anything that was transferred or disposed of in other ways from the assets of the company by means of a voidable transaction to the company. Since a German corporation like company with limited liability or a stock corporation will be dissolved upon the commencement of insolvency proceedings (unless the shareholders resolve upon a continuation of the company following the successful implementation of a reorganisation plan), the insolvency administrator will not literally be regarded as an office holder for the company, but represents the insolvency estate consisting of any assets that belong to the company at the time of the commencement of the proceedings as well as acquired during the course of the insolvency proceedings.

QUESTION 6

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6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 Introduction

In respect of the aforementioned actions giving rise to liability of directors, a German civil court will order directors to pay compensation to the party who suffered the damages while a German criminal court will sentence the directors to imprisonment or fines in accordance with the level of personal guilt. As to civil liability, compensations might be claimed either by the company i.e. the insolvency estate represented by the insolvency administrator as office holder (see above), or by a creditor, shareholder, public authority or any other third party dealing with the company. Transactions which are successfully challenged by the insolvency administrator will result in a court order to return the assets to the insolvency estate. Since the German Insolvency Code provides for a detailed ranking of pre-petition claims and administrative claims, an order postponing debt owed by a company to rank after other debts is not required.

6.2 Overview

Actions giving rise to liability	Legal consequences / orders available to the court
Duty to convene a shareholders' meeting	Damage compensation to be paid by directors to the company (civil liability) Imprisonment up to 3 years or fine
Duty to petition for the commencement of insolvency proceedings	Damage compensation to be paid to "new creditors" (see above) or to insolvency administrator (joint damage) Imprisonment up to 3 years or fine
Liability vis-à-vis social security authorities	Damage compensation to be paid to authorities Imprisonment up to 5 years or fine
Fraudulent trading /crimes pertaining to insolvency	Damage compensation to be paid to crime victims Imprisonment up to 5 years or fine Disqualification from acting as director for 5 years following the time when sentence became final by virtue of law
Liability arising from the causation of insolvency proceedings	Damage compensation to be paid to company
Breach of agreement providing security	Damage compensation to creditor who were to be secured
Group liability / Piercing the corporate veil	Damage compensation to be paid to company
Violation of capital maintenance rules	Damage compensation to be paid to company
Liability vis-à-vis tax authorities	Damage compensation to be paid to authorities

QUESTION 7

7. Duty to co-operate

To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

The German Insolvency Code imposes extensive duties of information and co-operation of the debtor with respect to insolvency proceedings vis-à-vis the insolvency administrator. In the event that the debtor is a corporation, such duties apply analogously to all members of the executive or supervisory boards. In addition to the members on such boards, other parties involved in the insolvency proceedings such as creditors in possession of security or any other parties to whom assets of the insolvent companies were transferred by way of an potential voidable transaction can be compelled to co-operate with the insolvency administrator.

Any resignation of directors in proximity to the commencement of insolvency proceedings will not result in any discharge from the duties to provide information relevant to the insolvency proceeding to the insolvency court, the insolvency administrator or the creditors' committee. Thus, information and co-operation duties apply to persons, who left any of the aforementioned positions not earlier than two years prior to the commencement of the insolvency proceeding.

As to the level of co-operation, the German Insolvency Code states that the directors shall assist the insolvency administrator in the performance of his duties and furthermore shall make themselves available at the order of the court for this purpose. Any aforementioned duty may be enforced by the insolvency court, ordering the directors to make an affidavit to the effect that the information provided is correct and complete. Finally, the court may force the debtor to appear and could take the director into custody if the director refuses to comply with his information and co-operation duties.

In practice, the aforementioned information and co-operation duties can hardly be distinguished from rendering services by a director to the extent of a service or employment contract. However, according to prevailing opinions in legal literature, the directors are not obligated to render their full working strength without remuneration.

Clearly, the German Insolvency Code does not recognise the defence of privilege against self-information with regard to the aforementioned information and co-operation duties, so that directors are obligated to disclose even facts which are likely to result in the prosecution of a crime or administrative offence. However, any use of such information in criminal proceedings requires the consent of the director.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

Actions giving rise to liability	**Limitation periods** **a) Limitations on prosecution** **b) Limitations on enforcement of claims**
Duty to convene a shareholders' meeting	a) 5 years as soon as the crime is completed b) 3 years starting as soon as the injured party has knowledge of injury
Duty to petition for the commencement of insolvency proceedings	a) 5 years starting as soon as the duty of directors to petition for insolvency proceedings ceased to exist (e.g. if over-indebtedness has been removed) b) 3 years starting as soon as the injured party has knowledge of injury 5 years with respect to claims to reimbursement of advance payments made in order to cover costs of proceedings
Liability vis-à-vis social security authorities	a) 5 years starting as soon as the duty of directors to petition for insolvency proceedings ceased to exist (example given if over-indebtedness has been removed) b) 3 years starting as soon as the injured party has knowledge of injury

Fraud /crimes pertaining to insolvency	a) 5 years starting as soon as the duty of directors to petition for insolvency proceedings ceased to exist (example given if over-indebtedness has been removed) b) 3 years starting as soon as the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period
Liability arising from the causation of insolvency proceedings	b) 3 years as soon as the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period (civil liability)
Breach of agreement	b) 3 years, unless special limitation periods apply
Piercing the corporate veil	b) 3 years starting with the emergence of the claim and the obligee's awareness of circumstances giving rise to the claim and the identity of the obligor
Violation of capital maintenance rules	b) 5 years starting at the time of the violation
Liability vis-à-vis tax authorities	b) 4 years regarding tax assessment
Disqualification of directors	Disqualified as managing director for 5 years following the time when sentence became final, unless court ruling imposing disqualification provides for a longer time period

8.2 Appeals

Generally, any decision of the first instance court in penal or civil proceedings might be the subject of an appeal, unless the civil courts of the first instance orders damage compensation which does not exceed the amount of 600.

As outlined above, any disqualification of directors result from a sentence or side sanctions ordered by a criminal court, the order of which might be appealed against.

QUESTION 9

9. Foreign corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

Any legal provisions and procedures outlined above apply to domestic corporations which do not have a personally liable shareholder or partner. With respect to liabilities vis-à-vis public authorities and liabilities arising from any crimes pertaining to insolvency and any breach of agreements, the aforementioned legal provisions apply irrespective of the legal form and legal seat as long as the business transactions of the company are operated in Germany.

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 Coverage available

"Directors and Officers" insurance covering the exposure of directors of German corporations are emerging in the German insurance market. It has been introduced by the U.S. and British insurance companies which have a substantial background in their respective foreign market, an urgent need of directors to protect themselves against personal liability which may arise in connection with the aforementioned actions, has been caused by a more proactive attitude of insolvency creditors to recover their losses from the directors. It is expected that the German courts will strengthen their demands as to the compliance of directors with their duties, namely their duty to petition for the commencement of insolvency proceedings, respectively to be aware of the current financial situation of the company resulting in such duty. On the other hand, any premature petition for the commencement of insolvency proceedings is also not advisable because this could be regarded as a general violation of the managing duties of directors and, therefore, could lead to compensation claims of the company.

Following the approach of probably all German insurance companies, the coverage of risks does not include intentional or "consciously" negligent misconduct of directors.

Furthermore, according to the common practise in the U.S., the insurance companies used by the company directors or executive staff tend to exclude protection against internal liability vis-à-vis the company. Such exclusion of internal liability is historically based on the risk of so-called shareholder derivative lawsuits, i.e. shareholders claiming compensation on behalf of the company from their directors. Despite the fact that such lawsuits are generally not recognised in Germany, insurance companies fear potential abuse of such coverage which could enable the directors to act collusively with the shareholders in order to enrich the assets of the company. However, the exclusion of the exposure arising from internal liability is not a satisfactory solution for directors from a practical perspective because various cases of civil liability result in a duty to compensate the company and not the outstanding creditors.

In summary, protection is only available with respect to claims of outstanding creditors arising from a merely negligent violation of duties. However, even this protection may prove not to be effective bearing in mind that in practise, the dividing line between “merely” negligence on the one side, and “conscious” negligence or “contingent” intention on the other side, is difficult to determine. Directors may already act “consciously” negligent if they consider the existence of a financial crisis as “probable”. As far as insolvency-related crimes resulting in a civil liability are concerned, criteria and procedure determining illiquidity and over-indebtedness are complex, so that the misconduct of directors in this respect is “slightly” negligent rather than “consciously” negligent or intentional. The failure to transfer deducted taxes or social contributions will be regarded as intentional or “consciously” negligent conduct if the director is completely aware of the circumstances constituting his duty as well as of the duty itself.

10.2. Claims to reimbursement or indemnification

In addition to insurance protection, indemnification for third party claims or company claims against the directors might be considered as an option.

Certainly, directors are entitled to reimbursement or indemnification by the company to the extent that the compensations claimed against the directors were to be paid out of the assets of the company, such as wage taxes or social security contributions.

The German Federal Court held that a company with limited liability might indemnify directors of a company with limited liability with respect to claims of third parties due to the implementation of instructions of shareholders urging directors to violate their duties. Apart from this, general indemnification by the company on a contractual basis is only permissible as far as this indemnification to be paid from the company assets will not endanger claims of outstanding creditors. This principle is applicable with respect to third party claims as well as to claims of the company against its directors.

Due to the punitive character, directors cannot recover any fines imposed in the course of criminal prosecution.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 Directors incurring further credit

Certainly, continued demand of funds in the Twilight Period, in particular fresh money to avoid illiquidity and/or over-indebtedness, compels directors to seek further funding either by shareholders or third parties, i.e. lenders or suppliers. As mentioned above, directors would commit a fraud and become personally liable vis-à-vis third parties in the event that they incur further credit by way of encouraging lenders or suppliers to grant additional loans or to render advance performance without directors having any prospects of being able to redeem the loans or pay the consideration. Moreover, directors exploiting their own personal trust rather than acting merely as a representative of the distressed company when incurring further credit vis-à-vis third parties might become personally liable in the event that the security provided could finally not be successfully realised by the creditor due to an action to set aside or for practical reasons.

11.2 Counter-party risks

Shareholders providing loans at a time when a prudent businessman would have made contributions into the company's equity capital instead granting a loan, can only claim redemption of the loan in insolvency proceedings as so-called subordinate insolvency creditors, i.e. following the complete satisfaction of the ordinary non-subordinated insolvency creditors. The aforementioned financial situation of a distressed company will be deemed to exist once the company is no longer capable of incurring further credits which accrue interest in accordance with market prices. Alternatively, loans will be regarded as replacing equity in the event that any other unconnected third party acting as a reasonable creditor would decline to grant loans according to the same terms as the shareholder actually did. Any redemption of loans granted in lieu of equity might be set aside by the insolvency administrator if the redemption was effected in the last year prior to the petition for the commencement of insolvency proceedings or following such petition. Security provided for the redemption of a loan in lieu of capital might even be set aside if it was effected in the last ten years prior to the petition for the commencement of insolvency proceedings or following such petition.

As outlined above, the lending strategies of banks are the subject of a controversial discussion with respect to the voidability of a transfer of assets by the distressed company serving as security for loans granted by lenders in the "Twilight Period".

HONG KONG

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 Notwithstanding Hong Kong's return to Chinese sovereignty in 1997, Hong Kong remains a common law jurisdiction and the law relating to corporations is largely based on the law of England prior to the implementation of the recommendations of the Cork Report. As in England, when considering whether a transaction may be vulnerable to attack or might result in personal liability, a key question is whether the company was insolvent at the time of or as a result of the transaction concerned. The twilight period effectively runs for the duration of the company's insolvency until the commencement of liquidation (presentation of a winding-up petition in the case of compulsory liquidation and the passing of the resolution to wind up in the case of voluntary liquidation).[1]

A company is insolvent when it is unable to pay its debts. There are two predominant tests of a company's inability to pay its debts.[2] They are:

(a) the "cash-flow" test - a company is insolvent when it is unable to pay its debts when they fall due; and

(b) the "balance sheet" test - a company is insolvent when its assets are insufficient to meet its liabilities.

1.1.2 The obligations of the directors of a company change fundamentally once a company is insolvent. In normal circumstances where a company is solvent, directors owe their duties to the company, that is, to its present and future members, who are entitled to ratify any breaches of duty by the directors. Where a company is insolvent however, it is the creditors rather than the members which are likely to suffer as a result of such breaches. Accordingly, where a company is insolvent the directors owe their duties to the creditors (through the company) and must exercise their powers with a view to minimising the potential loss to creditors.

1.2 Vulnerability periods

1.2.1 The various clawback periods under Hong Kong law, being periods terminating at the commencement of liquidation, are:

(a) unfair preferences - 6 months (2 years for associates) (s.266 Companies Ordinance (Cap 32)) ("**CO**");

[1] Section 184 Companies Ordinance (Cap 32)

[2] The tests to establish insolvency or inability to pay debts are derived from case law. There is no definition of 'inability to pay debts' or of 'insolvency' in the Companies Ordinance.

(b) floating charges - 12 months (s.267 CO);

(c) extortionate credit transactions - 3 years (s.264B CO);

(d) disposition after presentation of petition - from date of presentation (s.182 CO); and

(e) fraudulent conveyances - no time limit (s.60 Conveyancing and Property Ordinance).

Under current legislation, transactions at an undervalue are only vulnerable in personal bankruptcy.

QUESTION 2

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2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the “twilight” period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

  (i) is any resulting liability against a director civil, criminal or both?;

  (ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

  (iii) will liability attach to individual directors in proportion to their specific involvement?;

  (iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

  (v) what defences, if any, will be available in relation to each offence?

2.1 Introduction

2.1.1 Hong Kong law provides a fairly wide range of offences for which a director may be held personally liable during the “twilight period” with the exception being the absence of an equivalent to the English law provision for wrongful trading. In 1995 the Law Reform Commission of Hong Kong proposed an ‘insolvent trading’ provision (a mixture of wrongful trading under English law[3] and insolvent trading under Australian law[4]) based on the recommendations of the Cork Report. A draft provision was incorporated in the Companies

[3] Section 214 Insolvency Act 1986 ("IA 1986").

[4] Corporations Act 2001 (Aust) Part 5.7B.

(Corporate Rescue) Bill brought before the Legislative Council in 2001. Various provisions in the Bill have been the subject of criticism by relevant professional bodies and the Bill is still at the committee stage subject to a further round of consultation. It is not clear when (or if) the Bill will be implemented.

2.1.3 Despite this wide range of offences, prosecution proceedings against directors (and other persons who may be caught by these provisions) for any of the statutory offences set out in 2.2 to 2.7 below are uncommon, with the exception of the offence for officers failing to keep proper accounts.[5]

2.2 Fraudulent trading[6]

(a) Although Hong Kong does not yet have 'wrongful' or 'insolvent' trading legislation, directors can become liable for fraudulent trading. As is the case under English law,[7] actual dishonesty is an essential element to establishing liability for fraudulent trading under Hong Kong law. As is the case in other jurisdictions with provisions similar to s.275 CO, it is rare for persons to be found liable for fraudulent trading due to the difficulty of proving dishonesty.[8]

Liability for fraudulent trading is incurred if it can be shown in the course of the winding-up of a company that 'any business of the company has been carried on with the intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose'. The elements of this provision are:

(i) the company must be in an insolvent liquidation for civil liability to be incurred (s.275(1) CO) whereas criminal liability may be incurred irrespective of whether the company is in an insolvent liquidation or not (s.275(3) CO);

(ii) there must be actual intention to defraud creditors or to achieve a particular fraudulent purpose whilst running the business[9] or recklessness as to whether the carrying on of the business would result in the creditors being defrauded;

(iii) the standard of proof for civil liability is the balance of probabilities (i.e. the civil standard of proof)[10] whereas for criminal liability proof 'beyond reasonable doubt' is required; and

(iv) any 'knowing party' to the dishonest manner in which the business is being run may incur liability, which may therefore extend beyond any director, shadow director or officeholder (potentially to a financier who funded a fraudulent trade knowing it was being done dishonestly).[11]

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5 According to the Official Receiver's Annual Report for 2001-2, the only offence from all those listed in 2.2-2.6 below in respect of which proceedings were commenced was section 274 CO(officers for failing to keep proper accounts) (see 2.5 below).

6 Section 275 CO.

7 Section 213 IA 1986.

8 There are only two reported cases in Hong Kong where proceedings have been brought for fraudulent trading, neither of which were successful :*Re Parvinos Lines Ltd* (1985) CWU NO 37 of 1977 and *Aktieselskabat Dansk Skibsfinansiering v Wheelock Marden and Co Ltd* [2000] HKCFA 31.

9 This includes a single act and it need not be established that a series of acts were conducted

10 *Aktieselskabat Dansk Skibsfinansiering v Wheelock Marden and Co Ltd* [2000] HKCFA 31

11 See 2.2 (v) of the England Chapter: Re *Bank of Credit and Commerce International SA* (No.2), *Banque Arabe et Internationale D'Investissement SA v Morris* [2000] All ER (D) 1437).

(b) (i) Liability may be civil and/or criminal depending on whether the company is in an insolvent liquidation (see 2.2(a)(i) above).

(ii) Any damages award is to compensate the company for any loss caused and is not intended as a punitive measure. The court has a wide discretion in this regard to the extent that a 'knowing party' may be held liable for all loss caused.

(iii) Although the court has a wide discretion, it will exercise that discretion with regard to proportionality.

(iv) There is no specific period before commencement of the insolvent liquidation during which the dishonest act must have been committed either in relation to civil or criminal liability being incurred.

(v) The main defence is absence of dishonesty. A person who is alleged to have committed this offence need only show an honest belief that there was a reasonable prospect that the company would be able to pay the debts which it incurred to avoid liability. It is immaterial that objectively the director would be considered imprudent or incompetent in holding such a view.

2.3 Frauds by officers of companies which have gone into liquidation[12]

(a) It is an offence for an officer[13] of the company:

(i) to make or cause to be made any gift, or transfer of or charge on or to have caused or connived at the levying of any execution against the property of the company with the intent to defraud creditors; or

(ii) to have concealed or removed any part of the property of the company since, or within two months before, the date of any unsatisfied judgement or order for payment of money obtained against the company.

(b) (i) Liability under this provision is criminal.

(ii) A person guilty of this offence is liable to imprisonment and a fine.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The relevant act may be committed:

(A) in respect of (a)(i) above, any time before the commencement of the insolvent liquidation; and

(B) in respect of (a)(ii) above, any time after the date of any unsatisfied judgment or order for payment of money obtained against the company or within two months prior to such judgement or order.[14]

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12 Section 273 CO

13 Officer includes the directors, managers and secretary of the company (see 3.3 below).

14 There is no specific time limit in the equivalent English law provision for the second limb of this offence (see fn 15 below).

(v) The main defence is absence of intent to defraud creditors.[15]

2.4 Offences by officers of companies in liquidation[16]

Fraud in anticipation of winding-up[17]

(a) It is an offence for any officer[18] or shadow director[19] of a company, whether past or present to:

(i) conceal any part of the property of the company to the value of HK$100 or upwards, or conceal any debt due to or from the company;

(ii) fraudulently remove any part of the property of the company to the value of HK$100 or upwards; or

(iii) pawn, pledge or dispose of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging or disposing is in the ordinary course of the business of the company.

(b) (i) Liability for each of the above offences is criminal.

(ii) A person guilty of offences (a)(i) and (ii) above is liable to both imprisonment and a fine whereas liability for offence (a)(iii) above is limited to imprisonment.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The relevant act may be committed:

(A) within 12 months before the commencement of the winding-up of the company; or

(B) any time after the commencement of winding-up.

(v) Possible defences are:

(A) for offences (a)(i) and (iii), absence of intent to defraud;[20] and

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15 The burden of proof for the equivalent English law provision (section 207 IA 1986) is on the defendant, not the prosecution - the accused is deemed to have committed the offence in the event of the particular circumstances unless the defendant can prove an absence of intent to defraud creditors with an additional defence that the relevant act must have occurred within five years prior to the commencement of the winding-up. In 1998, the Law Reform Commission in Hong Kong recommended that this provision be amended to reflect section 207 IA 1986 but there is no indication that any such amendment will be made.

16 Section 271 CO

17 Sections 271 (d), (e) and (o) CO

18 Officer includes the directors, managers and secretary of the company (see 3.3 below).

19 A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 3.2.5 below).

20 The burden of proof under the equivalent English law provision is on the defendant not the prosecution as the accused is deemed to have committed the offence in the event of the particular circumstances unless the defendant can prove an absence of intent to defraud creditors. In 1998, the Law Reform Commission recommended that this provision be amended to shift the burden of proof to the defendant but there is no indication that any such amendment will be made.

(B) for offences (a)(i), (ii) and (iii), any officer may be excused by the court if shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.[21]

Misconduct in the course of winding-up[22]

(a) It is an offence for any officer[23] or a shadow director[24] of the company, whether past or present:

(i) not, to the best of his knowledge and belief, to fully and truly discover to the liquidator all the property, real and personal, of the company and how, to whom, for what consideration and when the company disposed of any such property (except any disposals in the ordinary course of its business);

(ii) not to deliver up to the liquidator any real and personal property of the company in his custody or control (including any books and papers of the company);

(iii) in the knowledge or belief that a false debt has been proved by any person, to fail to inform the liquidator within one month;

(iv) to prevent the production of any book or paper affecting or relating to the property or affairs of the company after commencement of the winding-up;

(v) to make any material omission in any statement relating to the affairs of the company; and

(vi) to attempt to account for any part of the company's property by fictitious losses or expenses.

(b) (i) Liability for each of the above offences is criminal.

(ii) A person guilty of any of the above offences is liable to both imprisonment and a fine.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The relevant act in relation to each of the above offences may be committed at any time before the commencement of or during the winding-up of the company, except for offence (a)(vi) which must occur either during the winding-up or at any meeting of creditors of the company within 12 months prior to the commencement of the winding-up.

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21 Section 358 CO. The court rarely makes such orders.

22 Sections 271(a), (b), (c), (f) (g) (h) and (l) CO

23 Officer includes the directors, managers and secretary of the company (see 3.3 below).

24 A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 3.2.5 below).

(v) Possible defences are:

(A) for offences (a)(i), (ii) and (v) above, absence of intent to defraud;

(B) for offences (a)(iv) above, absence of intent to conceal the state of affairs of the company or to defeat the law; and

(C) for each of the above offences, any officer may be excused by the court if shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.[25]

Falsification of company's books [26]

(a) It is an offence for any officer[27] or a shadow director[28] of the company, whether past or present to:

(i) conceal, destroy, mutilate or falsify any book or paper affecting or relating to the property or affairs of the company, or to be privy to any such action;

(ii) fraudulently part with, alter, make any omission in any document affecting the property or affairs of the company, or to be privy to any such action; or

(iii) make any false entry in any book or paper affecting or relating to the property or affairs of the company, or to be privy to such action.

(b) (i) Liability for all of the above offences is criminal.

(ii) A person guilty of any of the above offences is liable to both imprisonment and a fine.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The relevant act may be committed within 12 months before the commencement of the winding-up of the company or during the course of the winding-up.

(v) Possible defences are:

(A) for offence (a)(i) and (ii) above, absence of intent to conceal the state of affairs of the company or to defeat the law;[29]

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25 Section 358 CO. The court rarely makes such orders.

26 Section 271 (i), (j) and (k) CO.

27 Officer includes the directors, managers and secretary of the company (see 3.3 below).

28 A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 3.2.5 below).

29 The burden of proof for the equivalent English law provision is on the defendant not the prosecution as the accused is deemed to have committed the offence in the event of the particular circumstances unless the defendant can prove there was no intent to conceal the state of affairs of the company or to defeat the law. In 1998, the Law Reform Commission recommended that this provision be amended to shift the burden of proof to the defendant but there is no indication that any such amendment will be made.

(B) for each of the above offences, any officer may be excused by the court if it can be shown that he has acted honestly and reasonably and, having regard to all the circumstances of the case, he ought fairly to be excused.[30]

False representation to creditors[31]

(a) It is an offence for any officer[32] or shadow director[33] of the company, whether past or present to falsely represent or commit any fraud for the purpose of obtaining the consent of the company's creditors or any of them to an agreement with reference to the state of the company's affairs or to the winding-up.

(b) (i) Liability is criminal.

(ii) A person guilty of this offence is liable to both imprisonment and a fine.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The representation may be made any time before or after the commencement of winding-up.

(v) The defence is absence of intent to mislead the company's creditors into giving their consent on the basis of a false premise.

2.5 Liability where proper accounts not kept[34]

(a) It is an offence for an officer[35] or shadow director of a company who knowingly and willfully authorises or permits the failure[36] to keep proper books of account during the two years before commencement of the winding-up (or between incorporation of the company and its winding-up if a lesser period). "Proper" books of account means those necessary to exhibit and explain the transactions and financial position of the business of the company (including, where relevant, day-to-day entries of cash paid and received, statements of annual stocktakings, etc.).

(b) (i) Liability for this offence is criminal.

(ii) A person guilty is liable to both imprisonment and a fine.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

30 Section 358 CO. The court rarely makes such orders.
31 Section 273(p) CO.
32 Officer includes the directors, managers and secretary of the company (see 3.3 below).
33 A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 3.2.5 below).
34 Section 274 CO. Liability under this provision constitutes a ground for determining whether or not a director is unfit to be a director under 15th Schedule and Section 168H (see 2.10.4(iii) below)).
35 Officer includes the directors, managers and secretary of the company (see 3.3 below).
36 Section 351(2) CO.

(iv) The relevant act must have taken place within two years prior to the commencement of winding-up.
(v) It is a defence if the accused can prove both an absence of dishonesty and that in the circumstances the failure was excusable.

2.6 Penalty for falsification of books[37]

(a) It is an offence for any officer[38] of the company (whether past or present) or a contributory to destroy, mutilate, alter or falsify any book, papers or securities, or make any false or fraudulent entry (or be privy to such entry) in any register, book of account or document of the company with the intent to defraud or deceive any person.

(b) (i) Liability for this offence is criminal.

(ii) A person guilty of any of the above offences is liable to both imprisonment and a fine.

(iii) The court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The relevant act may be committed any time before or during the course of the winding up of the company.

(v) A defence is absence of intent to defraud or deceive any person.

2.7 Misfeasance[39]

(a) A past or present officer[40] or any person who has taken part in the formation or promotion of the company will be liable if found to have misapplied or retained or become liable or accountable for any money or property of the company or is found guilty of any misfeasance or breach of fiduciary duty.

(b) (i) Liability for this offence is civil.

(ii) Any damages award is to compensate the company for any loss caused and is not intended as a punitive measure. The court has a wide discretion to compel the officer to repay or restore the money or any part of it with interest as it considers just.

(iii) Although the court has a wide discretion, the discretion will be exercised with regard to proportionality.

(iv) There is no time period in which the relevant act must have been committeddone for a person to be caught under this provision, except under the Limitation Ordinance.[41]

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[37] Section 272 CO.
[38] Officer includes the directors, managers and secretary of the company (see 3.3 below).
[39] Section 276 CO.
[40] Officer includes directors, managers and secretary of the company (see 3.3 below).
[41] Limitation Ordinance (Cap 347).

(v) Any officer of the company may be excused by the court if it can be shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.[42]

2.8 General fiduciary duties owed to a company

(a) The duties of a director are those applying to all fiduciaries and are based on acting with the utmost good faith towards the company, that is, its present and future members. However, as a company approaches insolvency, directors must also begin to take into account the interests of the company's creditors. When a company is insolvent, the interests of the creditors override the members' interests. The fiduciary duties of directors are as follows:

(i) to act honestly and in good faith in the best interests of the company;

(ii) to exercise their powers for proper purpose;

(iii) to avoid any conflict between their duties as a director and their personal interests; and

(iv) not to make a secret profit.

(b) (i) Liability for breach of a director's fiduciary duty is civil.

(ii) Liability is for all loss caused to the company by the breach of duty subject to the usual rules of recoverability based on considerations of causation and remoteness of damage.

(iii) Directors found to have acted in breach of their fiduciary duties are jointly and severally liable for the entire loss. However, the court can allocate contributions as between the defendant directors taking into consideration their respective levels of culpability.[43]

(iv) There is no time limit within which action must be taken against a director except under the Limitation Ordinance.[44]

(v) Any director may be relieved by the court in whole or in part on such terms as it thinks fit from liability for a breach of fiduciary duty if it can be shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.[45]

2.9 Common law duties of skill and care

(a) The common law duties of a director are subject to an overriding duty to have regard to the interests of the company's general creditors once it becomes insolvent. These duties are to:

(i) exhibit a degree of skill as may be reasonably expected from a person with his knowledge and experience or that may reasonably be expected of a person in his position; and

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42 Section 358 CO.
43 Civil Liability (Contribution) Ordinance (Cap. 377).
44 Limitation Ordinance (Cap 347).
45 Section 358 CO.

(ii) exercise such skill and care as an ordinary man would use in relation to his own affairs.

(b) (i) Liability for breach of this duty is civil.

(ii) The court will award damages to compensate the company for the loss that has been suffered as a result of the director's breach of duty.

(iii) Directors found to have acted in breach of their common law duty are jointly and severally liable for the entire loss. However, the court can allocate contributions as between the defendant directors taking into consideration their respective levels of culpability.[46]

(iv) There is no time limit within which action must be taken against a director except under the Limitation Ordinance.[47]

(v) Any director may be relieved by the court in whole or in part on such terms as it thinks fit from liability for a breach of fiduciary duty if shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.[48]

2.10 Standard of fiduciary and common law duties owed by executive and non-executive directors

2.10.1 The courts have declined to make any distinction between executive and non-executive directors when assessing whether a director has met the requirements imposed by his fiduciary and common law duties. However, the court may take into account the 'position' of the director, such as whether his functions are discharged on a part-time basis.[49]

2.10.2 The fiduciary and common law duties of a director may be extended by contractual arrangement (e.g. a director who has a service contract may have additional contractual duties) but they cannot be limited or reduced by way of contractual arrangement. Section 165(3) CO mirrors s.310 of the English Companies Act 1985, prohibiting any provision in a contract or in a company's memorandum or articles of association which exempts any officer of the company from liability for breach of duty.

2.10.3 In the absence of an employment contract the non-executive will clearly not owe any contractual duties of care to the company. It is accepted that the non-executive may rely on his co-directors to carry out various tasks and functions, however, this does not abrogate his responsibility to inform himself about the company's affairs and to join with his co-directors in supervising and controlling them. The non-executive may rely on a co-director to the extent that any matter lies within the co-director's sphere of responsibility having regard to the way the business of the company is organised and where there exist no reasons for supposing that this reliance is misplaced. Note that the extent to which a non-executive may reasonably rely on the executive directors and other professionals to perform his own duties is an area in which the law is developing and has been described as 'fact sensitive'.

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46 Civil Liability (Contribution) Ordinance (Cap. 377).
47 Limitation Ordinance (Cap 347).
48 Section 358 CO.
49 See 2.14.1 of the England Chapter.

2.11 Liability of directors to disqualification for acts done in the twilight zone[50]

2.11.1 The provisions in the Companies Ordinance providing for disqualification of directors are based upon the Company Directors Disqualification Act 1986 ("**CDDA**").[51] Under Hong Kong law, a court may order that a person who is appointed as a director be disqualified or, if not holding such a position, be restricted from being a director or taking part in the management, formation or promotion of a company, for a period of up to fifteen years.

2.11.2 There is no definitive 'twilight zone' for directors in respect of liability for disqualification. Some grounds for disqualification do not require that the company is insolvent either at the time or after the person commits the relevant acts. Where the company is required to be or subsequently to have become insolvent, there are no specific periods in which the director must have committed the acts prior to the insolvency of the company.

2.11.3 As under the CDDA, there is no provision under Hong Kong law for automatic disqualification. It should be noted that where a person is found liable for fraudulent trading, the court has a discretion to make a disqualification order against such person irrespective of whether an application for a disqualification order is made.[52]

2.11.4 Apart from where a disqualification order is made as part of the sentence imposed following conviction for a crime, disqualification proceedings have been held to be civil in nature. However, a person who contravenes a disqualification order commits a criminal offence and is liable to imprisonment and a fine.[53]

Grounds for disqualification

2.11.5 There are five grounds for disqualification. The two grounds which can apply to a company outside of insolvency, are:

(i) where any person has persistently breached requirements of the Companies Ordinance for the filing of any return, account or other delivery to the Registrar;[54] and

(ii) where a person is convicted of an indictable offence in connection with the promotion, formation, management or liquidation of the company or any other indictable offence which involves dishonesty.[55]

The three remaining grounds require that the company is insolvent at the time of the relevant conduct or subsequently becomes insolvent. These grounds are:

(iii) where it appears that a person is guilty of fraudulent trading (criminal

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[50] Part IVA CO.
[51] See 2.16 of the England Chapter.
[52] Section 168L CO.
[53] Section 168M CO.
[54] Section 168F CO.
[55] Section 168E CO. Examples include section 273 and section 276 of CO.

liability) or otherwise guilty while being an officer[56] or shadow director[57] of the company of any fraud or breach of duty[58] in the course of the winding-up of the company;[59]

(iv) where a court is satisfied that the conduct of a past or present director[60] or shadow director[61] of an insolvent company, makes him unfit to be concerned in the management of a company[62] (the court has no discretion as to whether the director is disqualified in the event that unfitness is proved);[63] and

(v) where a director is found liable for fraudulent trading (irrespective of whether an application for a disqualification order was made).[64]

2.11.6 There is no statutory definition of 'unfitness' but certain factors may be taken into account when determining the fitness of a director. These are listed in the Fifteenth Schedule of the Companies Ordinance which mirrors the First Schedule of CDDA. The list includes factors that apply whether a company is solvent or not, such as breach of fiduciary duty, misfeasance and misapplication of company property, and those factors which apply specifically to insolvent companies, such as the causes of the company's insolvency and the company entering into any transaction or giving any preference which is liable to be set aside.[65] The list may be modified by order of the Financial Secretary and is not exclusive. The court will look at any matters or acts relevant to the conduct of the affairs of the company and its insolvency, such as the statutory requirements for keeping proper books of account, delivering the company's property to the liquidator and compiling the statement of affairs. An action for disqualification relying on this ground must be made within four years of the date of commencement of winding-up.[66]

Length of disqualification

2.11.7 The maximum period of disqualification is generally 15 years. It is in the court's discretion to fix the period of disqualification subject to this limit (and the jurisdiction of the court in the case of being disqualified on conviction of an indictable offence).[67] The Hong Kong court has applied the guidelines set down by the English Court of Appeal which divides cases into three categories according to their severity;[68]

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56 Officer includes directors, managers and secretary of the company (see 3.3 below).

57 A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 3.2.5 below).

58 Conviction under section 275 of CO is not required, the court need only to have taken the view that the person is guilty of such an offence.

59 Section 168G CO.

60 A director includes a person duly appointed as a director and any person occupying the position of director by whatever name called (see 3.2.4 below).

61 A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 3.2.5 below).

62 Section 168H CO.

63 Section 168H(1) CO.

64 Section 168L CO.

65 Section 266B CO - see 4.3.1 below.

66 Section 168I(2) CO.

67 Section 168E(3) CO.

68 Re *Observers Travel Enterprise Co Ltd* (In Liquidation) [2001] HKCFI 78 applying Re *Sevenoaks Stationers (Retail) Limited* (1991) CoA.

(i) 10-15 years for particularly serious cases, such as where a director is disqualified for a second time;[69]

(ii) 6-10 years for serious cases which do not merit the top bracket;[70] and

(iii) 1- 5 years for cases which are relatively not very serious.[71]

2.11.8 Enforcement of disqualification orders in Hong Kong is the primary responsibility of government regulators (particularly the Official Receiver's Office), however, the following should be noted:

(i) If a court finds a person liable for fraudulent trading under s.168L, it may make a disqualification order whether or not it has been applied for.

(ii) An application for disqualification relying on (A) conviction of an indictable offence under s.168E or (B) where it appears a person is guilty of fraudulent trading (criminal liability) or otherwise guilty while being an officer of any fraud or breach of duty in the course of the winding-up of the company under s.168G, may also be brought by the Financial Secretary, the liquidator, any past or present member or creditor of any company against which that person has committed an offence or default.

(iii) An application for disqualification relying on the 'unfitness' ground may be brought by either the Official Receiver or the Financial Secretary as long as it is considered to be in the public interest.[72] Liquidators and receivers have a duty to report any matter which appears to relate to the unfitness of a director to the Official Receiver who may then report the matter to the Financial Secretary[73] with a view to determining whether there is a case for disqualification proceedings on the ground of unfitness to be instituted.

Duty to co-operate

2.11.9 Liquidators have the power under the Companies Ordinance to require directors to provide certain information and deliver up the company's property to them and the court to penalise directors for failing to co-operate (see section 7 below for more detail).

2.11.10 Disqualification proceedings on the grounds of unfitness (s.168H) must be brought within four years of the day on which the company was wound up unless leave of the court is obtained. There is no time limit prescribed for an application relying on any other ground.

Foreign corporations

2.11.11 There is no territorial restriction to the jurisdiction of the Hong Kong court to make a disqualification order. An order can be made against either a foreign

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69 In 2001-2002, the maximum disqualification period in Hong Kong was six years.

70 An example was in Re *Observer Travel Enterprise Co Ltd* where the director was found to have lacked commercial probity and had personally benefited from the creditor's expense and was disqualified for a period of six years.

71 There is a minimum requirement of a one-year period where a director is disqualified on the grounds of being unfit (Section 168H) (Re *Emperor Hotel Management Co Ltd* (2002)).

72 Section 168I(1) CO.

73 A total of 947 reports were filed by liquidators and receivers in 2001-2.

national or resident abroad in relation to a Hong Kong incorporated company or registered overseas company[74] and includes acts committed abroad. It is necessary that either the company in question or some other company with which the person has been connected is the subject of insolvency proceedings in Hong Kong.

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Introduction

3.1.1 Hong Kong law is similar to English law in that it may impose liability on a wide variety of persons who have been involved in the management of a company during the twilight period depending on the particular act or offence. Hong Kong law recognises that a company's affairs during this time may not only be influenced by those formally appointed as directors but also by a wide range of other people. If such people have caused loss to the company and its creditors during this time, they may also be found personally liable for such loss.

3.1.2 Liability first extends in certain circumstances to those persons who act as directors but have not been formally appointed, that is, "shadow directors" and "de facto" directors. Hong Kong law mirrors English law in respect of the meaning of these concepts and is explained in more detail below. In addition, officers of the company (apart from directors) who are involved in the affairs of the company during the twilight zone may also be held liable. Finally, there are third parties who are not in any way involved in the management of the company but who may be a party to transactions during the twilight zone which are vulnerable to challenge, such as unfair preferences. A third party may also have knowledge of a breach of duty of a director when entering into a transaction and either fraudulently assisted in that breach and/or received

[74] Any company that is capable of being wound up in Hong Kong (Section 168C(1) CO).

property from the company with knowledge of that breach. Under general equitable principles, such a person may be liable as a constructive trustee of such property and be liable to return it or to pay compensation to the company.

3.2 De facto and shadow directors

3.2.1 There are persons under Hong Kong law who are recognised and treated in the same way as directors despite not being formally appointed. The concept of "de facto" directors originated under common law to deal with persons who, though not technically appointed as directors as a matter of company law, are still treated as directors due to the function they carry out and role they play in the affairs of the company. In addition, Hong Kong legislation has introduced the concept of "shadow directors", that is, those persons who are not directors or do not seem to have any role in the decision- making process of a company but are nevertheless controlling the company through its directors from behind the scenes.

De facto

3.2.2 A "de facto" director is a person who whilst not formally appointed (due to a technical default in his appointment or otherwise) or registered as a director nonetheless acts as and performs the functions of a director and is treated as such by the rest of the board. "Director" is defined under Hong Kong law as "any person occupying the position of director by whatever name called"[75] and therefore includes those persons who are called by other names but participate in decisions of the type made by directors.

3.2.3 There is no distinction under Hong Kong law between de facto and formally appointed directors. Both owe the same duties and are under the same statutory obligations. De facto directors may be exposed to additional liability if they dispose of company property because the fact that they are not directors means that they lack the necessary authority. Unless the shareholders in general meeting resolve to ratify the disposals, de facto directors may be liable to compensate the company for the value of the assets wrongfully disposed of. This right of action vests in the company.

3.2.4 De facto directors have the ability to bind the company in making contracts with third parties acting in good faith in their capacity as agents of the company with actual and/or apparent authority. Under principles of general agency law, they are not personally liable under those contracts but may be liable in damages for breach of an implied warranty of authority if they can be deemed to have warranted that they had authority to act on behalf of the company when no such authority existed.

Shadow directors

3.2.5 A shadow director is defined under Hong Kong law as "a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act" but a "person shall not be considered to be a shadow director of a company by reason only that the

[75] Section 2(1) CO.

directors or a majority of the directors of the company act on advice given by him in a professional capacity”.[76]

3.2.6 There have been few cases in Hong Kong where the courts have had to consider the meaning of “shadow director”. The English Court of Appeal decision in *SSTI v Deverell* (2000) (in which the statutory definition of shadow director in the Companies Act 1985 was reviewed) has not yet been considered, although it will probably have a significant influence on the approach of the Hong Kong court.

3.3 Officers

Liability for many of the offences set out above is not limited to those persons acting as directors but, by reference to the ‘officers’ of the company, extends to other persons who are managing the affairs of the company. Unlike the English law position, this is a defined term in the Companies Ordinance meaning a director,[77] manager or secretary; a manager is defined as ‘a person who, under the immediate authority of the board of directors, exercises managerial functions’ but does not include receivers and special managers.[78] This definition suggests that a manager is limited to only those at a more senior level who are exercising managerial functions as such person must be ‘under the immediate authority’ of the board.

3.4 Other third parties that may be held liable

3.4.1 Liquidators and receivers may be found liable for misfeasance or breach of duty owed to the company.[79]

3.4.2 Third parties may be held liable for some of the above offences.

(i) If a third party receives property as a result of an unfair preference, that person will be liable to return the property and/or provide compensation as the court thinks fit with a view to restoring the position to what it would have been had the unfair preference not occurred.

(ii) If a third party receives property of the company which has been disposed of after the winding-up order has been made without the court’s consent, that disposal will be void.[80]

(iii) A third party will be liable for fraudulent trading if that person is knowingly party to the carrying on of a business with an intent to defraud creditors.[81] As stated above, the ‘carrying on of a business’ need only constitute a single act. It is likely that an employee who merely carries out orders will not be liable but that a person must have taken a positive step.[82]

(iv) Any third party who has dishonestly assisted in a breach of duty by a director or other officer of a company or knowingly received property

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76 Sections 2(1) and (2) CO.
77 This includes de facto directors by virtue of the definition of director (see 3.2.2).
78 Section 2(1) CO.
79 Section 276 CO.
80 Section 182 CO.
81 Section 275 CO.
82 This is the common law position under English Law (see BCCI v Christopher Morris [2000] All ER (D) 1437.

arising from such a breach will be liable for any loss arising. This applies to all circumstances and is not limited to actions taken in the 'twilight zone' and falls within the Hong Kong court's equitable jurisdiction.

(v) Any third party who takes in or receives property of a company knowing it to be pawned, pledged or disposed of in the course of the winding up of the company (or 12 months prior its commencement) for the purpose of obtaining credit and which has not been paid for incurs criminal liability. It is a defence if the third party can prove an absence of intent to defraud.[83]

3.5 Summary

Liability may attach to persons not formally appointed as directors for the following offences:

Offence/activity	*Persons Liable*	*Extent of Liability*
Fraudulent trading (s.275 CO)	Any person who was knowingly a party to the carrying on of the business for a fraudulent purpose (including persons dealing with the company who receive property with knowledge of the fraud)	Same as for director
Fraud by officers of companies which have gone in to liquidation (s.273 CO)	Officers of the company at the time of the fraud[84]	Same as for director
Offences by officers of companies in liquidation (s.271 CO)	Any officer or shadow director of the company at the time of the offence[84] s.271(o) offence includes third parties who take property of the company in the knowledge that is pawned, pledged of disposed of for the purpose of obtaining credit which has not been paid for - see section 3.4(v) above	Same as for director
Liability where proper accounts not kept (s.274 CO)	Officers[84] and shadow directors[85] (who knowingly and wilfully authorisze or permit the default) of the company at the time of the default	Same as for director

[83] Section 271(2) CO.
[84] Note definition of officers in 3.3 above.
[85] Section 351(2) CO defines the reference to 'defaulting officer'.

Offence/activity	*Persons Liable*	*Extent of Liability*
Falsification of books (s.272 CO)	Officers[84] or contributories of the company at the time of the offence	Same as for director
Misfeasance (s.276 CO)	Any past or present officer[84], liquidator or receiver of the company, auditor and any person who has taken part in the formation or promotion of the company	Same as for director
Unfair Preference (s.266 CO)	Creditor, surety and guarantor	The court has discretion to restore the position to what it would have been had the preference never been made (e.g. return of property)
Dishonestly assisting or knowingly receiving property or assets in breach of duty	Any person with the requisite degree of "knowledge" who knowingly assists in a breach of duty owed by a person to a company or knowingly receives property from a breach of duty owed to the company	Where requisite knowledge and other applicable conditions are satisfied, a person may be held to be a constructive trustee of the property and required to return such property or pay compensation equal to the loss caused

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Introduction

The provisions under Hong Kong law allowing for transactions which are to the detriment of a company and/or unfairly beneficial to a counterparty to be overturned reflect the English law provisions except in one significant respect. There are no means by which a person can challenge transactions which are at an undervalue in relation to a corporate insolvency.[86] This considerably

[86] The equivalent English law provisions are section 238 IA 1986 and section 423 IA 1986.

weakens the Hong Kong regime as the alternatives, unfair preference and fraudulent conveyance, both require *mens rea* on the part of the person acting on behalf of the company.

4.2 Summary of heads of challenge

The potential heads of challenge which may lead to transactions with the company being set aside from the point of view of a counterparty, are as follows:

(a) unfair preferences

(b) fraudulent conveyances

(c) extortionate credit transactions

(d) granting of floating charges for past value

(e) breach of a director's fiduciary duties

(f) transactions comprising onerous property

(g) transactions constituting a disposition of company property after the commencement of the winding-up

(h) transactions comprising an unregistered charge

4.3 Unfair preference

4.3.1 An unfair preference occurs when an act of the company, whilst when it is insolvent but before the commencement of its winding-up, has the effect of putting a creditor in a better position in the company's winding-up than it would have been in if the company had not taken such action. The liquidator is the only person who may challenge such transactions. If the challenge is successful, the court has a wide range of powers to exercise in its discretion to restore the position to what it would have been if the company had not entered into the relevant transaction.[87]

Conditions for setting aside the transaction

4.3.2 The following conditions must be satisfied to challenge a transaction successfully:

(1) the company must be in liquidation and the application challenging the transaction must be made by the liquidator;[88]

(2) the transaction must take place during the 'relevant' periods which end with the commencement of the winding-up of the company.[89] The applicable period depends on the identity of the preferred person and is:

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87 This provision (section 266B CO) was amended in 1998 to reflect Section 239 IA. This was achieved by incorporating the relevant sections of the Hong Kong Bankruptcy laws by reference which has left significant gaps in the definition of a corporate entity's associate (see 4.3.3 below).

88 Section 50(1) Bankruptcy Ordinance (Cap 6).

89 The commencement of the winding-up of the company for the purpose of this section is the day on which the

(A) 2 years for an unfair preference given to an 'associate'; and

(B) 6 months for an unfair preference given to any other person.

(3) the company is 'insolvent'[90] at the time of the transaction.

4.3.3 There is no satisfactory definition of an 'associate' of a company,[91] because the application of unfair preference provisions to companies is achieved only by incorporation of the relevant sections of the Bankruptcy Ordinance (which apply only to individuals). Obviously a company can not be treated in the same manner as a natural person as a company has no spouse or relatives. Those persons falling within the definition of an associate company are as follows:

(i) any person in partnership with a company;

(ii) any person who employs or is employed by the company (directors and other officers are treated as employees under this provision);

(iii) a person who is a trustee of a trust and the beneficiaries of the trust include or the terms of the trust confer a power that may be exercised for the benefit of the company or an associate of the company; and

(iv) another company which is 'controlled' by the company in liquidation or if the company in liquidation and associates of that company together have control.[92]

4.3.4 It should be noted that those persons not falling within the definition of an associate company are as follows:

(i) a subsidiary of the company in liquidation is an associate as the company in liquidation is in control of it but a holding or parent company is not as the company in liquidation is not the one in control;

(ii) directors are associates but only because they are regarded as employed by the debtor company but the spouse or relatives of the director are not associates; and

(iii) director does not include shadow director for the purpose of this provision.

What is a preference?

4.3.5 A company gives an unfair preference if:

(1) the creditor who is preferred is one of the company's creditors (including surety or guarantor for any of the company's debts or liabilities);[93] and

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90 The meaning of 'insolvent' is where the debtor is unable to pay his debts as they fall due or the value of the company's assets is less than the amount of its liabilities (taking into account contingent and prospective liabilities) (section 51(3) Bankruptcy Ordinance (Cap 6)).

91 Section 51B Bankruptcy Ordinance (Cap 6).

92 One company (A) is controlled by another (B) where (i) the directors of A or of another company which has control of A are accustomed to act in accordance with the directions or instructions of B (except if B is giving advice in a professional capacity) or (ii) B is entitled to exercise or control the exercise of one-third or more of the voting power at any general meeting of A or of a company which has control of A (section 51B(8) Bankruptcy Ordinance (Cap 6).

93 Section 50(3)(a) Bankruptcy Ordinance (Cap 6).

(2) the company does anything or suffers anything to be done which has the effect of putting that creditor in the event of the company's insolvency in a better position than if that thing had not been done.

4.3.6 The test to determine whether a creditor has been preferred is whether the creditor is better off in the event of the company's winding-up; that the statutory order of priorities is in some way disturbed.

Defences

4.3.7 The court shall not make an order under this section unless the company who gave the unfair preference was influenced in deciding to give it by a desire to give a preference to that person.[94] This is a question of fact. The English court's comments on the equivalent section of the Insolvency Act will be regarded as persuasive in Hong Kong.[95]

4.3.8 If the creditor is an 'associate' of the company (unless by reason only of being its employee), there is a presumption that the company was influenced by such a desire, unless the contrary is shown. As directors and other officers of a company are only associates by virtue of being deemed to be employees, this presumption does not apply to them.

4.3.9 The court may not make an order if:

(i) it would prejudice any interest in the property which was acquired from a person other than the company and was acquired in good faith and for value, or prejudice any interest deriving from such interest; or

(ii) it would require a person who has received a benefit from the unfair preference in good faith and for value to pay a sum to the liquidator (except where the payment is in respect of an unfair preference given at a time when he was a creditor of the company).[96]

4.3.10 There is a presumption that the benefit of the preference was not acquired in good faith if the creditor had notice of the circumstances amounting to the unfair preference or of the liquidation proceedings at the time of the unfair preference or the preferred person was an associate of the company or the creditor to whom the company gave the unfair preference.

4.4 Fraudulent conveyance[97]

4.4.1 A transaction may be set aside by the court if it amounts to a disposition of property with the 'intent to defraud creditors'. Although a provision of the Conveyancing and Property Ordinance this applies not only to land but to all forms of property. A liquidator or a creditor may apply to court for relief. There are no specific time limits attached to this section. This provision is rarely relied upon due to the difficulty in proving the intention to defraud.

4.4.2 The main defences are (i) absence of intention to defraud creditors, and (ii) that the property was disposed of for valuable consideration and in good faith

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[94] Section 50(5) Bankruptcy Ordinance (Cap 6).
[95] See 4.4.6 of the England Chapter.
[96] Section 51B(2) Bankruptcy Ordinance (Cap 6).
[97] Section 60 Conveyancing and Property Ordinance (Cap 219).

or upon good consideration and in good faith to any person not having, at the time of the disposition, notice of the intent to defraud creditors.

4.5 Extortionate credit transactions[98]

Conditions

4.5.1 The court may set aside or vary a transaction for or involving the provision of credit to the company if:

(1) the company is or has been a party to the transaction;

(2) the company is in liquidation;

(3) application is made by the liquidator;

(4) the transaction was ‘extortionate’; and

(5) the transaction was entered into within three years before the commencement of the voluntary winding-up or date of the winding-up order.

4.5.2 A transaction is regarded as extortionate if, having regard to the risk accepted by the person providing the credit:

(1) the terms of it are or were such as to require grossly extortionate payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit; or

(2) it otherwise grossly contravenes ordinary principles of fair dealing.

This provision aims to prevent oppression where one of the parties is taking improper advantage of an imbalance in bargaining power.

4.5.3 There is a rebuttable presumption that a transaction is extortionate if an application is made under this provision.[99]

Defences

4.5.4 There are no statutory defences.

4.6 Effect of floating charge

4.6.1 The aim of this provision is to prevent insolvent companies creating floating charges over their property to secure past debts and so prefer a certain creditor to the prejudice of their general unsecured creditors.[100]

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98 Section 264B of CO and is derived from the equivalent provision under English law (section 244 IA 1986).

99 Section 264B(3) CO.

100 Section 267 CO. The purpose of this section is the same as the equivalent provision under English law (section 245 IA 1986) but the Hong Kong provision is far less detailed, such that English case law in respect of section 245 IA 1986 may not apply in Hong Kong.

Conditions for setting aside

4.6.2 A liquidator of an insolvent company may treat a charge as void[101] if:

(1) the charge was created as a floating charge (whether or not it is still floating at the time of the commencement of the winding-up);

(2) it was created within 12 months prior to the commencement of the winding-up;

(3) the company was insolvent at the time it was created; and

(4) the charge was given otherwise than for new consideration.

4.6.3 A charge will be valid to the extent of any cash paid to the company at the time or subsequent to the creation of the charge in consideration of the charge. 'Cash paid to the company' has been interpreted to include cheques or the equivalent of cash (such as goods or services) and payments made direct to the company's creditors (as long as the cash is intended to benefit the company and not certain creditors).

4.6.4 This section does not have a retrospective effect and therefore does not apply to floating charges created and enforced within the 12 months prior to the commencement of the winding-up.

Defences

4.6.5 There are no specific statutory defences except to the extent that it can be proved that the company was solvent immediately after the charge was created or that the charge is valid to the extent that any new consideration was given.

4.6.6 The practical situations set out in section 4.7.6 of the England Chapter have application in Hong Kong.

4.7 Breach by directors of general/common law duties

4.7.1 If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general common law duty to put the company's interests first. Where the counterparty has knowledge of this, there may be circumstances where there are proprietary or restitutionary rights to recover the property. These are rights under the general law and, whilst not dependent upon insolvency, are more likely to be examined and/or exercised after a formal insolvency event.

4.8 **Disclaimer of onerous property in case of company wound up**[102]

4.8.1 A liquidator in the course of the winding-up of a company may with leave of the court disclaim 'onerous' property of the company notwithstanding that the liquidator has attempted to sell, take possession or exercise any act of ownership in relation to the property. If the liquidator does not disclaim the

101 No application need be made by the liquidator to the court unless the property is controlled by the party claiming security.

102 Section 268 CO.

property within 12 months of the commencement of winding-up (or if the liquidator does not know of such property one month after the commencement of the winding-up, within 12 months of becoming aware of it), consent of the court for an extension of this period must be obtained.

4.8.2 'Onerous' property includes (i) land burdened with onerous covenants, (ii) shares or stock in companies, (iii) unprofitable contracts and (iv) any other property which is unsaleable or not readily saleable by reason of some onerous act or payment being required.

4.8.3 The purpose of the disclaimer is to determine the rights, interest and liabilities of the company in or respect to the property of the company as from the date of the disclaimer and therefore does not affect rights and liabilities already accrued. Third parties are only to be effected so far as necessary to release the company and its property from liability. Any person suffering loss or damage as a consequence of the disclaimer is deemed to be a creditor of the company and may prove the amount lost as a debt in the winding-up of the company.[103]

4.8.4 If the liquidator fails to take action in respect of burdened property, any interested person may force the liquidator to make a decision by serving notice. If the liquidator fails to give notice of intention to apply to the court for leave to disclaim within 28 days after receipt of the notice to him, the liquidator will not be able to disclaim thereafter.

4.9 Avoidance of dispositions of property after commencement of winding-up[104]

4.9.1 In a winding- up by the court, any disposition of the property of the company, including things in action, transfer of shares, alteration in status of the members of the company, shall be void if made after the commencement of the winding-up. The purpose of this section is to preserve the status quo and support the principle of *pari passu* distribution of the company's assets.

4.9.2 The commencement of the winding-up is from the date of presentation of the winding-up petition.

4.9.3 This section applies to all dispositions unless a court order is obtained validating the transaction. An application may be made by the company, liquidator, contributory or any interested person for a validating order. Leave will only be given if there is no serious prejudice to the creditors or it is likely to improve the position of all the company's creditors (such as if the disposition enables the company to trade profitably).

4.10 Failure to register a charge

4.10.1 Hong Kong operates a system of registration of security similar to the system in England. If a Hong Kong incorporated company creates any security (in Hong Kong or elsewhere) over property located in Hong Kong or elsewhere, or an overseas company with a place of business in Hong Kong creates security over property located in Hong Kong, that security must be registered

[103] Section 268(7) CO.
[104] Section 182 CO.

within five weeks of its creation. Failure to do so renders the security void against a liquidator and any creditor of the company. It is the company's duty to register the charge[105] but any person who is interested in the charge may and should do so.

4.10.2 Those charges that must be registered are:

(a) charge for the purpose of securing any issue of debentures;

(b) charge on uncalled share capital of the company;

(c) charge created or evidenced by an instrument which if executed by an individual would require registration as a bill of sale;

(d) charge on land wherever situated or any interest therein but not including a charge for any rent or other periodical sum issuing out of land;

(e) charge on book debts of the company;

(f) floating charge on the undertaking or property of the company;

(g) charge on calls made but not paid;

(h) charge on a ship or any share in a ship; and

(i) charge on goodwill, on a patent or a licence under a patent on a trademark or on a copyright or a licencelicence under a copyright.

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Introduction

5.1.1 A liquidator is required to review the action taken by directors and other persons involved in the affairs of the company during the twilight period as part of his duty to collect and then realise all the property and assets of the company for the benefit of creditors. If the circumstances require, he is obliged also to bring proceedings to obtain compensation for the company for any loss caused to the company by persons interested in the company, including directors. As a result, it is the liquidator who in most cases is empowered to bring proceedings against directors. Even in those cases where other persons interested in the company may bring proceedings against directors (as listed in the table below), the

105 Section 81 CO.

proceedings are usually commenced by the liquidator. This rule does not apply to criminal proceedings.

5.2 Criminal proceedings

5.2.1 The Secretary for Justice is responsible for bringing criminal proceedings in Hong Kong against directors and any other persons. A liquidator is under a duty to bring any such offences to the attention of the Secretary for Justice and, in the event that an offence is not reported, any person may apply to court for a direction that the matter be referred.[106]

5.2.2 There is a general right for any person to bring criminal proceedings by way of private prosecution, however, the Secretary for Justice may at any stage in proceedings before a magistrate intervene and assume the conduct of the proceedings.[107]

5.2.3 Criminal offences that may be brought against directors can be summarised as follows:

(a) Fraudulent trading (s.275 (3) CO)

(b) Fraud by officers of companies in liquidation (s.273 CO)

(c) Falsification of books (s.272 CO)

(d) Liability where proper accounts not kept (s.274 CO)

(e) Offences by officers of companies in liquidation (s.271 CO)

5.3 Civil proceedings

5.3.1 The insolvency regime in Hong Kong allows persons other than the liquidator to bring civil proceedings against directors for certain actions. Where an action for contribution to the company's assets is successful, any recoveries made will be for the benefit of all creditors and form part of the company's assets.

5.3.2 Only the Financial Secretary and Official Receiver may bring proceedings for disqualification on the grounds of unfitness to be a director (s.168H).

[106] Section 277(1) CO.
[107] Section 14(1) of the Magistrates Ordinance (Cap.227).

Activity/Transaction	*Person able to bring proceedings*
Misfeasance	Official Receiver, liquidator, creditor or contributory[108]
Fraudulent trading (civil liability) (s.275(1))	Official Receiver, liquidator, creditor or contributory
Unfair preference	Liquidator only
Fraudulent conveyance	Liquidator or any creditor
Extortionate credit transaction	Liquidator only
Disqualification as a director	
• s.168E, F and G	Official Receiver, Financial Secretary, liquidator and any past or present member or creditor against which that person has committed an offence or default (disqualification under s.168F may also be made by the Registrar)
• s.168H	Financial Secretary or Official receiver (if in the public interest)
• s.168K	At the court's discretion

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

Activity/Transaction	*Remedy Available*
Misfeasance	This section only provides the mechanism for enforcing existing duties arising before or during the winding-up by way of summary trial - it does not create any new liabilities or rights.
	The court may order a director to repay or restore the money or property (or any part of it) with interest at such rate as the court thinks just **or** to contribute such sum to the assets of the company by way of compensation in respect of the misfeasance or breach of trust as the court thinks just.

[108] A contributory is defined as any person liable to contribute to the assets of a company in the event of it being wound up and includes any person alleged to be a contributory prior to the final determination of those persons deemed contributories (section 171 CO).

Activity/Transaction	***Remedy Available***
Fraudulent trading *Criminal Liability (s.275(3) CO)*	 If trial by jury, the penalty is up to five years imprisonment and/or a fine (unlimited) and, on summary conviction, up to 12 months imprisonment and a fine of up to HK$150,000.
Civil Liability (s.275(1) CO)	A director may be held liable for all of the debts or other liabilities of the company (without any limitation of liability) as the court may direct. In exercising its discretion, the court is seeking to compensate the company for any loss and not to apply any punitive measure. Where a court makes a declaration under this section that a director is liable for all or any of the debts or liabilities of the company (i) the court may make an order that he be disqualified from acting as a director for a period of up to 15 years (irrespective of whether an application was made for such an order), and (ii) may give further directions to effect the declaration, such as imposing a charge on any debt or obligation due from the company to him or the deferral of debts due from the company to him.
Unfair preference	The court may make such order as it thinks fit for restoring the position to what it would have been had the transaction constituting the unfair preference not occurred. For example, it may order: (a) any property that was transferred as part of the transaction to be vested in the liquidator as part of the company's assets; (b) any property which represents the application of the proceeds of sale of the property or money wrongfully transferred to be vested in the liquidator as part of the company's assets; (c) the release or discharge of any security given by the company; (d) any person to pay such sums representing the value of any benefits received by him from the company in breach of this section to the company; (e) any obligations of a surety or guarantor which were released or discharged in breach of this section to be revived on terms as the court thinks fit; (f) security to be provided for the discharge of any obligation imposed by or arising under the order; and

Activity/Transaction	*Remedy Available*
	(g) any person whose property is vested by the order in the company, or on whom obligations are imposed, to be able to prove in the winding- up of the company for debts or other liabilities which arose from or were released or discharged under or by, the transaction or the giving of the preference. Any order under this section cannot prejudice any interest in property acquired from a person (other than the company) in good faith and for value. It must not require a person who received a benefit from the transaction constituting the unfair preference in good faith and for fair value to make payment except where that person was a party to the transaction with the company or was a creditor of the company at the time of the transaction.
Fraudulent conveyance	A transaction declared to be a fraudulent conveyance will be void. Any third party in possession of the property will be deemed to be holding the property on constructive trust for the liquidator. The court can order the property to be re-vested in the liquidator as part of the company's assets.
Extortionate credit transaction	The court may make any of the following orders: (a) set aside the whole or any part of any obligation created by the transaction; (b) vary the terms of the transaction or the terms on which any security for the purpose of the transaction is held; (c) require any person who is or was a party to the transaction to pay the liquidator any sums paid to that person by the company by virtue of the transaction; (d) require any person to surrender to the liquidator any property held by him as security for the purposes of the transaction; and (e) direct accounts to be taken between any persons.
Fraud by officers of companies in liquidation	If trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK$50,000.
Falsification of books	If trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK$50,000.
Liability for proper accounts	If trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK$50,000.

Activity/Transaction	*Remedy Available*
Offences by officers of companies in liquidation	
All offences under s.271 (except for (o))	If trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK$50,000.
s.271(o) (Pawn, pledge or disposal of property of the company obtained on credit which has not been paid for)	If trial by jury, the penalty is up to five years imprisonment and, on summary conviction, up to two years imprisonment.
Breach of fiduciary duties	The director may be ordered to compensate the company for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of his fiduciary duty.
Duties of skill and care	The director may be ordered to compensate the company for loss and damaged caused by breach of his fiduciary duty.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Introduction

There is no provision in the Companies Ordinance imposing a general duty on directors and other persons involved in the affairs of a company to co-operate with a liquidator, provisional liquidator or Official Receiver, as can be found under English law in s.235 IA 1986. Liquidators in Hong Kong must rely on the specific provisions which are set out below when investigating the company's affairs.

7.2 Obligation to assist with delivery of property to liquidator[109]

7.2.1 Any contributory, trustee, receiver, banker, agent or officer[110] of the company on notice from the liquidator must pay, deliver, convey, surrender or transfer any money, property, books or paper to which the company is entitled to the liquidator within the time specified in the notice.

Sanctions

7.2.2 In the event of non-compliance with the liquidator's demand, the court may make an order on application of the liquidator for such payment, delivery, or transfer[111].

7.3 Power to summon persons suspected of having property of the company[112]

7.3.1 This provision provides for the examination by the court in private of persons suspected of having in their possession property of the company or of having information concerning the company or its affairs or property. The application is usually made by the liquidator but, if he will not, any creditor or contributory may apply.[113]

7.3.2 Any time after the appointment of a provisional liquidator or the making of a winding-up order, the court may summon to appear before it any of the following persons:

(a) any officer of the company;

(b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; and

(c) any person whom the court deems capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.

7.3.2 Any of the above persons may be required by the court to do any of the following:

(a) be examined on oath, provide responses in writing and sign any document containing such responses; and

(b) produce any books and papers in that person's custody or power (without prejudice to any lien).

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109 Section 211 CO.

110 Officer includes directors, managers and secretary of the company (see 3.3 above).

111 Company winding-up Rules r67.

112 Section 221 CO.

113 A liquidator need not show a prima facie case when applying for a private examination, only 'mere suspicion' (Re *Gold Co* 1879) 12 Ch D 770, whereas a creditor or contributory seems to have to prove a prima facie case (Re *Rolls Razor Ltd* (No 2)) [1970] Ch 576.

Sanctions

7.3.3 If a person is summoned to attend the court for examination after being provided a reasonable sum for expenses and refuses to attend, the court may order that he be apprehended and brought before the court for examination (subject to there being no lawful impediment made known to the court).

7.4 Power to order public examination of officers[114]

7.4.1 Where a company is being wound - up (either by the court or voluntarily), the Official Receiver or liquidator may apply to the court for the public examination of an officer[115] in relation to the promotion or formation or conduct of the business of the company or as to his conduct and dealings as an officer. The court may only make such an order if the liquidator or Official Receiver has submitted to the court a report stating that in his opinion a fraud has been committed by that officer of the company in relation to the company since its formation (or that person in the promotion or formation of the company).

Sanctions

7.4.2 The court may issue a warrant for the arrest of a person or officer who is to be subject to a public examination on proof of service of the notice informing such person of the time and place for the examination, if:

(a) such officer or person fails to attend the examination and no good cause is shown by him for such failure; or

(b) the Official Receiver or liquidator can satisfy the court that such officer or person has or is about to abscond before the hearing with a view to avoiding examination.[116]

7.5 Company's statement of affairs[117]

7.5.1 Where a winding-up order has been made or a provisional liquidator has been appointed, either the liquidator or provisional liquidator may require certain people to submit and verify by affidavit a statement of affairs of the company. The statement must show the particulars of assets, debts, liabilities, names, addresses and occupations of its creditors, securities held by the company and any other information required by the liquidator or provisional liquidator. Any of the following persons may be required to provide and verify such statements:

(a) current or former directors or officers[114] of the company;

(b) any person who has taken part in the formation of the company at any time within one year before the relevant date;

(c) any current employee of the company (or any person employed by the company within the previous 12 months) who the liquidator or provisional liquidator considers to be capable of giving the information; and

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114 Section 222 CO.
115 Officer includes directors, managers and secretary of the company (see 3.3 above).
116 Companies (Winding-up) Rules r49-56.
117 Section190 CO.

(d) any person who is or has been within that year officers of, or in the employment of, a company which is, or within that year was, an officer of the company.

Sanction

7.5.2 Any person who defaults in complying with the requirements of this provision commits an offence and is liable for a fine of up to HK$50,000.[118] In addition, it is also an offence to make any material omission in the statement of affairs and such person will be liable to a fine and imprisonment.[119]

7.6 Sanction for failing to discover the company's property and papers[120]

7.6.1 Section 271 (Offences by officers of companies in liquidation) creates various offences for past and present officers of a company, whether the action occurred prior to or during the course of the winding-up of the company, if such officer:

(a) fails to the best of his knowledge and belief to discover to the liquidator the property of the company and when any property was disposed of;[121]

(b) fails to deliver up the liquidator all property of the company in his custody or control, including books and papers;[122]

(c) fails for a period of one month to inform the liquidator of any debt known or believed by that person to be false which has been submitted for proof in the liquidation;[123] and

(d) after the commencement of the winding-up, prevents production of books and papers relating to the company's property affairs.[124]

7.7 Human rights

7.7.1 The Hong Kong Bill of Rights Ordinance ("**BORO**") commenced operation on 8th June, 1991. It embodied the provisions of the International Covenant on Civil and Political Rights ("**ICCPR**") as applied to Hong Kong. The Basic Law of Hong Kong (Article 39) provides that the rights and freedoms enjoyed by Hong Kong residents shall not be restricted unless prescribed by law, and that such restriction shall not contravene the provisions in the ICCPR and International Covenant on Economic Social and Cultural Rights ("**ICESCR**"). Despite various amendments made to the BORO at the time of the handover in 1997 (mainly to ensure that the BORO did not prevail over the Basic Law), the court seems to have accepted that the purpose of the Bill is to implement the ICCPR and provides some form of a yardstick to test the validity of Hong Kong law.

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118 Section 190(5) CO.
119 Section 271(f) CO - see 2.4:Misconduct in course of winding-up (a)(v) above.
120 Section 271 CO.
121 Section 271(a) CO.
122 Section 271(b) and (c) CO.
123 Section 271 (g) CO.
124 Section 271 (h) CO.

7.7.2 The directors and others identified in question 3 will have rights under the BORO. In an insolvency context, a director or other person under BORO will be able to:

(a) require that a particular provision of insolvency law is construed in accordance with those rights or otherwise declared incompatible; or

(b) claim that the insolvency practitioner is a public authority and is acting unlawfully in breach of the BORO.

7.7.3 The application of the BORO will have the following effects:

(a) Legislation - primary and subordinate legislation will be read in a way that is compatible with the BORO. If this is not possible, the court may make a declaration of incompatibility. In the case of subordinate legislation, the court may give relief against any incompatibility provided that this is not inconsistent with the primary legislation; and

(b) Public authorities and the Government - it will be unlawful for public authorities and the Government (and any person or corporate entity acting on its behalf) to act in a way which is incompatible with a person's rights under the BORO. A victim may bring proceedings for judicial review or damages. The nature of the act must be public to be challenged under the BORO. As officers of the court, the Official Receiver, liquidators and provisional liquidators are all "public authorities" when carrying out functions of a public nature.

7.7.4 It should be noted that the court's interpretation of the BORO takes precedence over the rights afforded to individuals under the ICCPR and, in addition, the rights under the BORO are not absolute as they may well be limited by authorised interference by the government on the grounds of necessity. There have been few successful challenges under the BORO since 1997 and they have been limited to Hong Kong's criminal and administrative law.[125]

7.7.5 Those rights under the BORO which may be of some relevance are as follows:

(a) Article 10 - Right to a fair trial

All persons shall be equal before the courts and tribunals. In the determination of any criminal charge against him, or of his rights and obligations in a suit at law, everyone shall be entitled to a fair and public hearing by a competent, independent and impartial tribunal established by law. The press and the public may be excluded from all or part of a trial for reasons of morals, public order (order public) or national security in a democratic society, or when the interest of the private lives of the parties so requires, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice; but any judgment rendered in a criminal case or in a suit at law shall be made public except where the interest of juvenile persons otherwise requires or the proceedings concern matrimonial disputes or the guardianship of children.

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[125] For further information on Hong Kong's BORO see: Jumpstarting the Hong Kong Bill of Rights in is Second Decade? The Relevance of International and Comparative Jurisprudence by Andrew Brynes, HKU.

The scope of this Article is limited to criminal proceedings.

(b) Article 4 - No slavery or servitude

No one shall be required to perform forced or compulsory labour with the exception of any work or service which forms part of the civil obligations. An argument that work that a director may be required to do in complying with obligations to co-operate with an investigation into the company's affairs following its insolvency may be is forced labour, contrary to Article 4, is unlikely to succeed as the duties of co-operation are most likely to be part of a directors' normal civic obligations.

(c) Article 8 - Protection of privacy, family, home, correspondence, honour and reputation

This provides that no-one shall be subjected to arbitrary or unlawful interference with his privacy and correspondence. This article may give grounds for challenge where the investigation intrudes into the director's personal correspondence. The threshold of 'arbitrary' means that the interests of creditors are likely to prevail over most arguments that any examination or investigation is in breach of this article.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

(a) Criminal proceedings

Informations or complaints relating to offences under the Companies Ordinance (Cap. 32) identified in question 2 may be tried if they are laid or made at any time within three years after the commission of the offence and within 12 months after the date on which evidence sufficient in the opinion of the Secretary of Justice (as evidenced by a certificate of the Secretary of Justice) to justify the proceedings comes into his knowledge.[126]

126 Section 351A of the CO.

(b) Civil actions

(i) In relation to fraudulent trading the limitation period is generally six years from the date on which the cause of action accrued.[127]

(ii) In relation to breaches of fiduciary duties or misfeasance by directors the limitation period is generally six years from the date on which the cause of action accrued.[128] No limitation period will apply if it is an action in respect of a fraudulent breach of trust or to recover trust property or the proceeds of trust property which have been retained by a director or received by him and converted to his own use.[129] English case law has interpreted this widely so as to include the use of trust proceeds by a director for the benefit of a company he indirectly controls.[130]

(iii) In relation to breaches of common law duties of skill and care by directors, the limitation period is also 6six years from the date on which the cause of action accrued.[131]

(iv) In relation to any limitation period prescribed by the Limitation Ordinance (Cap.347) including those applicable to sub-paragraphs (b)(i) to (iii) above, if:

(1) there has been fraud of the defendant; or

(2) the plaintiff's right of action has been deliberately concealed from him by the defendant,

the limitation period shall not begin to run until the plaintiff has discovered the fraud or concealment or could with reasonable diligence have discovered it.[132]

(v) The limitation period applying to disqualification applications pursued under section 168H of the CO (Cap.32) is four years from the date on which the winding up of the company commenced or is deemed to have commenced, or in the case of a company that goes into receivership, the date on which the receiver vacated his office.[133] The court enjoys a discretion, however, to extend this period which may be exercised in circumstances where, for example, the delay is attributable to the failure of the director to cooperate, the charges laid against the director are serious, there is a public interest in ensuring

127 Section 4(1) of the Limitation Ordinance (Cap.347).

128 Sections 20(2) and 4(1) of the Limitation Ordinance (Cap.347).

129 Section 20(1) of the Limitation Ordinance (Cap.347).

130 Re Pantone 485 Ltd [2002] 1 B.C.L.C. 266 (relating to section 21(1) of the Limitation Act 1980 (UK)), which is highly persuasive authority in Hong Kong. The relevant Hong Kong legislation, section 20(1) of the Limitation Ordinance (Cap.347), is substantially the same as section 21(1) of the Limitation Act 1980 (UK).

131 Section 4(1) of the Limitation Ordinance (Cap.347) in the case of liability founded in tort. In an action based on negligence, the time limit may be extended under section 31 of the Limitation Ordinance in the event that the facts relevant to the cause of action were not known at the date on which it accrued. The extension allowed under this section is a further three-year period from the date on which the claimant had both the knowledge required to bring the claim and the right to do so. This is subject to a long stop under section 32 of the Limitation Ordinance which provides that no action shall be brought in respect of a negligence claim more than 15 years after the date on which the act of negligence relied upon occurred.

132 Section 26 of the Limitation Ordinance (Cap.347).

133 Section 168I(2) of the CO.

that the application is pursued or where the director would not suffer any specific prejudice as a result of the delay.[134] In exercising its discretion, the court will have to balance the public interest with the legitimate interest of the director and the possible prejudice which he might suffer if an extension were granted.

(vi) An application to the court based on unfair preference shall only be made with regard to any act made or done by or against a company within six months, or in the case of an unfair preference made in favour of an associate[135] of the company, two years, before the commencement of its winding- up.,[136] There is otherwise no limitation period for making such an application to the court.

8.2 Appeals

(a) Criminal appeals

(i) The Magistrates' Court, the District Court[137] and the Court of First Instance[138] each have criminal jurisdiction. Each have different sentencing powers. All summary offences are tried in the Magistrates' Court; only rarely will they be tried in the District Court.

(ii) While a Magistrate may, upon the application of a party, or of his or her own motion, review his or her decision in a matter which he or she has power to determine in a summary way,[139] all appeals from a Magistrate's decision are heard in the Court of First Instance.[140]

(iii) If a party believes that a decision of the Magistrate in respect of a conviction, order, determination or other proceedings which the Magistrate has power to decide in a summary way is erroneous in point of law, or is in excess of the Magistrate's jurisdiction[141], then that party may request the Magistrate to state and sign a case for the opinion of a judge of the Court of First Instance.[142] Leave of court is not required for this procedure to be invoked.

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134 Section 168I(2) of the CO. See also Re China Talent International Development Ltd (in liq) [2002] 4 HKC 344 and Re Tse Yu Hong Ltd & Others [2003] 2 HKLRD 332 for a discussion of the factors to be taken into account by the court in considering an application for leave to commence disqualification proceedings out of time.

135 Defined in section 51B of the Bankruptcy Ordinance (Cap.6).

136 Sections 266 and 266B of the CO.

137 Section 74 of the District Court Ordinance (Cap.336).

138 Section 12 of the High court Ordinance (Cap.4).

139 Section 104 of the Magistrates Ordinance (Cap.227); a magistrate may review questions of fact or law.

140 Sections 105, 113 and 113A of the Magistrates Ordinance (Cap.227); these provisions refer to 'appeals (or refers or states) to a judge' and although 'judge' is not defined in the Magistrates Ordinance, the definition of 'judge' in section 3 of the Interpretation and General Clauses Ordinance (Cap.1), read with section 2 of the Criminal Procedure Ordinance (Cap.221), indicates that the 'judge' is a judge of the Court of First Instance. See Halsbury's Laws of Hong Kong [130.909] and [130.926].

141 Section 105 of the Magistrates Ordinance (Cap.227).

142 Section 105 of the Magistrates Ordinance (Cap.227).

(iv) An appeal against any conviction, order or determination of a Magistrate by a person who did not plead guilty or admit the truth of an information or complaint may be made to a judge in the Court of First Instance[143] by giving the Magistrate's clerk a notice in writing.[144] No leave of court is required for such an appeal to be brought.

(v) An appeal against a sentence passed by a Magistrate[145] (except where the sentence is one fixed by law) may be made to a judge in the Court of First Instance by giving the Magistrate's clerk a notice in writing.[146] No leave of court is required for such an appeal to be brought.

(vi) A defendant may appeal to the Court of Appeal against his conviction by either the District Court[147] or the Court of First Instance:[148]

(1) as of right on any ground which involves a question of law; and

(2) with leave of the Court of Appeal, on any ground which involves a question of fact, a mixed question of law and fact or on any other ground.[149]

(vii) A person convicted of an offence on indictment by the District Court or the Court of First Instance may appeal to the Court of Appeal against any sentence (except where the sentence is one fixed by law) passed on him.[150] Where a person is not convicted on indictment, he may still appeal to the Court of Appeal if he is sentenced to imprisonment for a term of six months or more, or if the sentence is one which the court convicting him had no power to pass.[151] An appeal in these cases may only be brought with the leave of the Court of Appeal.[152]

(viii) The Secretary of Justice may appeal to the Court of Appeal against a verdict or order of acquittal of the District Court[153] based only on matters of law. No leave of court is required for such an appeal to be brought.

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143 Section 113 of the Magistrates Ordinance (Cap.227).

144 Section 114 of the Magistrates Ordinance (Cap.227).

145 This appeal is only available to a person who is convicted on any offence by a magistrate after pleading guilty or admitting the truth of the information or complaint (section 113(2) of the Magistrates Ordinance (Cap.227)).

146 Section 114 of the Magistrates Ordinance (Cap.227).

147 Section 13(3)(a) of the High court Ordinance (Cap.4). By virtue of section 83 of the District Court Ordinance (Cap.336), sections 80 to 83Y (which include appeal procedures) of the Criminal Procedure Ordinance (Cap.221) apply to criminal proceedings in the District Court.

148 Section 13(3)(a) of the High court Ordinance (Cap.4).

149 Section 82 of the Criminal Procedure Ordinance (Cap.221).

150 Section 83G of the Criminal Procedure Ordinance (Cap.221): by virtue of section 83 of the District Court Ordinance (Cap.336), sections 80 to 83Y (which include appeal procedures) of the Criminal Procedure Ordinance (Cap.221) apply to criminal proceedings in the District Court.

151 Section 83H of the Criminal Procedure Ordinance (Cap.221).

152 Section 83I of the Criminal Procedure Ordinance (Cap.221).

153 Section 84 of the District Court Ordinance (Cap.336).

(ix) The Secretary of Justice may, with leave of the Court of Appeal, apply to the Court of Appeal for the review of any sentence (except where the sentence is one fixed by law) passed by the District Court or the Court of First Instance on the grounds that the sentence is not authorised by law, is wrong in principle and/or is manifestly excessive or manifestly inadequate.[154]

(x) There may be an appeal to the court of Final Appeal from any final decision of the Court of Appeal or the Court of First Instance (if no appeal lies to the Court of Appeal).[155] Leave to appeal is required from the court of Final Appeal.[156] Leave will not be granted unless a point of law of great and general importance is involved or where substantial and grave injustice has been done.[157]

(b) Civil appeals

(i) Both the District Court[158] and the Court of First Instance[159] exercise civil jurisdiction. The jurisdiction to wind up a company is vested with the Court of First Instance.[160]

(ii) An appeal from a decision, judgement or order of the District Court or the Court of First Instance (subject to certain exceptions)[161] is heard in the Court of Appeal. While an appeal from the Court of First Instance is available to the parties as of right,[162] an appeal from the District Court can generally only be made with leave.[163]

(iii) An appeal from the Court of Appeal shall lie to the court of Final Appeal.[164] Parties may appeal to the court of Final Appeal as of right if the matter in dispute or the claim on appeal amounts to or is of the value of HK$1,000,000 or more.[165] An appeal may be permitted to be made to the court of Final Appeal at the discretion of the Court of Appeal or the court of Final Appeal if in the opinion of the Court of Appeal or the court of Final Appeal (as the case may be) the question involved in the appeal is one which, by reason of its great general or public importance, or otherwise, ought to be submitted to the court of Final Appeal for decision.[166]

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154 Section 81A(1) of the Criminal Procedure Ordinance (Cap.221).

155 Section 31 of the Hong Kong court of Final Appeal Ordinance (Cap.484).

156 Section 32 of the Hong Kong court of Final Appeal Ordinance (Cap.484).

157 Section 32(1) of the Hong Kong court of Final Appeal Ordinance (Cap.484).

158 Section 32(2) of the District Court Ordinance (Cap.336) which provides that the District Court may hear cases founded on contract, quasi-contract or tort where the plaintiff's claim does not exceed HK$1,000,000.

159 Section 12 of the High court Ordinance (Cap.4).

160 Section 176 of the CO.

161 See section 14(3) of the High court Ordinance (Cap.4).

162 Section 14 of the High court Ordinance (Cap.4); subsection (3) of the provision sets out the exceptions to the rule.

163 Section 63 of the District Court Ordinance (Cap.336); subsection (3) of the provision sets out the exceptions to the rule, namely where a person is found liable in contempt of court or for rescuing goods seized in execution or under a distress for rent, or where that person is made subject to an order for arrest or imprisonment for the enforcement of a judgement.

164 Section 22 of the Hong Kong court of Final Appeal Ordinance (Cap.484); an appeal to the court of Final Appeal shall only be made with leave of the Court of Appeal or the court of Final Appeal, provided that where an appeal lies as of right, leave to appeal shall not be refused (section 23 of the Hong Kong court of Final Appeal Ordinance (Cap.484)).

165 Section 22(1)(a) of the Hong Kong court of Final Appeal Ordinance (Cap.484).

166 Section 22(1)(b) of the Hong Kong court of Final Appeal Ordinance (Cap.484).

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Introduction

Part X of the CO deals with the winding up of unregistered companies. A 1997 amendment to s.326 of the CO clarified long-standing confusion as to the definition of "unregistered company" by stating that it included overseas companies certified as being registered under Part XI of the CO.[167]

9.2 Winding Up Unregistered Companies

Section 327 of the CO provides that any unregistered company may be wound up under the CO and that all of the provisions of the CO with respect to winding- up apply to unregistered companies. The primary exception is that no unregistered company may be wound up voluntarily.[168]

The circumstances in which an unregistered company may be wound up are:

(a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;

(b) if the company is unable to pay its debts; and

(c) if the court is of the opinion that it is just and equitable that the company should be wound up.[169]

Section 327(4) sets out the circumstances in which an unregistered company will be deemed unable to pay its debts.[170]

9.3 Exercise of Discretion

9.3.1 The court will not assume jurisdiction to wind up foreign companies in all circumstances but has developed certain tests to assist the court in deciding whether to exercise the discretion. These include:

(a) assets which are located in Hong Kong;[171]

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167 Section 326(2) of the CO.

168 Section 327(2) of the CO.

169 Section 327(3) of the CO.

170 Including the classic common law provision of failure to satisfy a statutory demand.

171 In Re *Irish Shipping Ltd* [1985] HKLR 437, the relevant company did not have any assets in the jurisdiction at the time of presentation of the petition however it did have a boat which arrived in Hong Kong in time for the hearing. This was considered to be sufficient nexus.

(b) a place of business which is located in Hong Kong; or

(c) the debt upon which the petition was founded was incurred in Hong Kong.

9.3.2 It may also be sufficient to demonstrate that there will be some benefit which accrues to the petitioning creditor or that one or more persons interested in the distribution of the company's assets are person over whom the court can exercise jurisdiction.

9.4 Application to Foreign directors

9.4.1 As stated above, all of the provisions relating to winding up in the CO relate to unregistered companies which are being wound up. English courts have held that the English court has jurisdiction in connection with an application relating to fraudulent trading being made against foreign directors.[172] This will be the case even where the relevant foreign jurisdiction has no equivalent provision although the English court would take into account the usual standard of care and duties expected of directors in the place of incorporation of the company before making an order. The same principle extends to other provisions relevant to directors and the practice of the English court would be highly persuasive in Hong Kong.

9.4.2 Other provisions in the CO relating to directors such as provision of information and disqualification also relate to directors of unregistered companies, subject to the considerations set out above, regardless of domicile.

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 Nature of directors' duties

10.1.1 The general duties applied to the conduct of every director and the circumstances in which personal liability may arise during the "twilight period" are considered above.

10.2 Indemnification

10.2.1 At common law, a director as agent or trustee of a company is entitled to indemnification for acts carried out on behalf of the company where he is acting within the powers conferred upon him.

172 *Re Howard Holdings Inc* [1998] BCC 549

10.2.2 That said, the scope of the indemnities a company can otherwise make available to a director is restricted by section 165 CO. Any provision (whether contained in the company's articles or in any contract with the company or otherwise) exempting any officer of the company (which means directors (and de facto directors), managers or secretaries (see section 3.3 above)) or any person employed by the company as auditor from, or indemnifying him against, any liability to the company or any related company that by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company is void (subsection (1) of section 165).

10.3 The availability of D&O liability insurance

10.3.1 Section 165, which was viewed as capable of voiding Directors' and Officers' ("**D&O**") liability insurance cover for directors, and thereby denying directors the benefit of insurance cover against negligence taken out by their company (when the same protection is generally available to other professionals), has recently been amended. New wording has been added in section 165(3) with effect from 13th February, 2004 to make it clear D&O liability insurance is permitted. The new subsection provides that:

"A company may purchase and maintain for any officer of the company, or any person employed by the company as auditor:-

(a) insurance against any liability to the company, a related company or any other party in respect of any negligence, default, breach of duty or breach of trust (save for fraud) of which he may be guilty in relation to the company or a related company; and

(b) insurance against any liability incurred by him in defending any proceedings, whether civil or criminal, taken against him for any negligence, default, breach of duty or breach of trust (including fraud) of which he may be guilty in relation to the company or a related company." (section 165 (3))

10.3.2 The Companies Ordinance also specifically permits a company to indemnify an officer or auditor against the liability incurred by him in defending civil or criminal proceedings in which judgment is given in his favour or in which he is acquitted (section 165(2)(a)).

10.3.3 It also permits an indemnity to operate if the court grants relief to the director for breach of trust, duty, negligence and default (section 165(2)() (b)). Section 358 Co gives a general power to a court to relieve a director from liability for negligence, default, breach of duty or breach of trust if it appears to the court that the director or officer concerned has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused wholly or partly from his liability.

10.4 Nature of D&O liability insurance

10.4.1 D&O liability insurance offers protection to directors and officers by covering them against civil liability and their defence costs for civil and criminal claims for wrongful acts (provided, in the latter case, they are found not guilty). The insurance will indemnify the directors for liabilities arising from acts committed in their capacity as directors and the cover provided will be subject to certain terms, conditions and exclusions. Following the changes outlined above to the Companies Ordinance, section165 now allows companies in Hong Kong to obtain insurance for directors and officers in respect of effectively all matters other than dishonesty, criminal penalties and claims by the company itself. This is subject to the following.

10.4.2 Although section 165(3) allows for an indemnity to be given to a director for the costs of defending proceedings in which it is alleged he acted fraudulently, it does not allow a director to be indemnified in relation to any personal liability the director may be found to have as a consequence of a finding of fraud. D&O insurers in practice and on grounds of public policy, always exclude, in any event, their liability to indemnify against any loss resulting from fraud.

10.4.3 Considering, however, that claims for indemnity under D&O liability insurance in Hong Kong are in the main part for the provision of defence costs to assist directors to fund the cost of defending litigation against them, the ability to advance defence costs is considered to be a positive step.

10.4.4 Also welcomed is that under section 165(3), it is no longer a requirement requisite that a claim against a director must be dismissed, or that he must be acquitted first, before cover is provided. This means that defence costs incurred in negotiating settlements (before the outcome of a trial) may now be advanced (depending on the specific terms of the policy).

10.5 Claims generally covered by D&O policies

10.5.1 D&O liability insurance will normally cover liabilities arising out of "wrongful" acts or omissions. This will include breaches of contract, torts, breaches of statutory duty and (in certain circumstances) breaches of fiduciary duty (claims brought by the company itself will not, however, be covered by insurance).

10.5.2 In all cases where claims are, in principle, covered by insurance, there will be no coverage in cases involving dishonesty or fraud. No insurance offers protection for fraudulent, dishonest or criminal acts committed by directors.

10.5.3 In cases of criminal liability, defence costs will be covered provided the director is not convicted of the offence. Hence, fines incurred by directors by virtue of their breaches of statutory duties will not be covered by the policy, but the costs for defending such criminal claims will be covered if the director is acquitted.

10.5.4 There is no legislation in Hong Kong relating to the insurability of punitive damages. It is not clear whether punitive damages are recoverable from an insurer, although there is an authority in the UK which suggests that they are recoverable.[173] Most standard D&O policies would, however, exclude this type of damages.

10.5.5 Claims brought by the company will not be covered but claims by aggrieved (usually minority) shareholders and liquidators may be covered, depending on the wording of the specific policy.

[173] Lancashire County Council v Municipal Mutual Insurance [1996] 3 All ER 545

10.5.6 Employment claims are generally excluded (but separate employment practice liability cover can be purchased).

10.5.7 The following is an executive summary of the types of duties generally imposed on directors, the manner in which they incur liability and whether insurance would be available in principle.

Type of claim	**Civil/ Criminal**	**Insurance available in principle?**	**Potential liability?**
Breach of duty of skill and care	Civil		
Breach of fiduciary duty e.g. duty to act in best interests of company etc.	Civil	(not available to cover Claims brought by company)	
Employment claims, e.g. sexual discrimination	Civil		Recent cases for US$100m (Cathay Pilots) HK$39m (Cap Gemini employee)
Contract claims	Civil		Loss suffered
Tort claim, e.g. misrepresentation	Civil		Loss suffered

Type of claim Companies Ordinance claims:	**Civil/ Criminal**	**Insurance available in principle?**	**Potential liability?**
Keeping of books/records	Criminal		12 months prison Fine: HK$300,000
Misleading statements to auditors	Criminal		2 years prison Fine: HK$150,000
Misleading statements in prospectus	Criminal		3 years prison Fine: HK$700,000
Failure to disclose material interest in contract	Criminal		Fine: HK$50,000
Granting of loan/ guarantee to director	Criminal		2 years prison Fine: HK$150,000
Disposal of assets, breach of restrictions	Criminal		6 months prison Fine: HK$50,000

Type of claim Securities & Futures Ordinance:	**Civil/ Criminal**	**Insurance available in principle**	**Potential liability?**
Non-disclosure of interests	Criminal		2 years prison Fine: HK$100,000
Misrepresentation	Criminal		7 years prison Fine: HK$1 million
	Civil		
False/Misleading public communications	Civil		
Market misconduct	Criminal		10 years prison Fine: HK$10 million
Breach of management responsibility	Civil		
Air pollution	Criminal		12 months prison Fine: HK$500,000
Unlawful waster disposal	Criminal		2 years prison Fine: HK$500,000
Water pollution	Criminal		2 years prison Fine: HK$1 million
Carrying out projects without environmental permit	Criminal		2 years prison Fine: HK$5 million
Noise pollution	Criminal		2 years prison Fine: HK$5 million
Signing cheques without specifying “for and on behalf of CLP”	Civil		Value of cheque
Carrying on business for fraudulent purpose	Civil Criminal		Value of debts
Corporate manslaughter	Criminal		Prison - variable
Contempt of court	Criminal		Fine-possibly c.HK$20,000
Liability under US securities laws	Civil[174]	unlikely given nature of offence)	

[174] There may be criminal liability as well - specialist US law advice required.

10.6 Coverage afforded under D&O liability insurance policies

10.6.1 This is normally divided into two sections:

(a) cover for the directors and officers (for an individual director there are a number of advantages in having a policy effected specifically for that director's own liability: the policy is unlikely to be invalidated by the actions of other members of the board of a company (by for example, failure to disclose all material facts in the policy application form); his personal policy may not be exhausted by claims against other members of the board; the insured can ensure his own policy does not lapse and his cover extends to a period beyond his departure from the company; there are no privity of contract concerns as to whether a director can claim on the company policy which he is not a party to); and

(b) company reimbursement. This indemnifies the company against matters for which the company is permitted to indemnify the director or officer under the articles of association to indemnify its directors and under the exception to section 165.

10.6.2 In addition, "entity coverage" may be provided in D&O liability insurance. This provides for the company to be insured in its own right for loss it may suffer. In the event of the company becoming insolvent, however, directors may face opposition from shareholders, a liquidator or trustee who consider that the limit of indemnity available under the D&O liability insurance (paid for by a company) represents an finite asset of the company which should not be eroded by the advancement of defence costs to a director.[175]

10.7 How the D&O policy works

10.7.1 There are policy and practical issues which must be considered, as well as steps which must be taken to effect D&O liability insurance. These include:

(a) The objects of the company must permit the company to obtain such insurance. Power should be granted to the directors in the articles to effect such insurance. Because it is a contract of the company, the directors must disclose their interest under the Companies Ordinance. The director should be authorised to vote notwithstanding this interest. The company must disclose the fact that it purchases or maintains directors' and officers' liability insurance in its annual report and accounts.

(b) The cover offered by the policy should be checked in advance. It is very important to compare policies to note difference in cover (particularly the scope of actions and potential liabilities covered by the policy; the conditions and exclusions (for example, US business); the definition of "wrongful acts" and "defence costs"; the financial limit on indemnities to claimants and whether for example, defence costs are in addition; any excess payable by the insured or the company in the event of a claim (for example, whether the excess payable by each individual director, or the limit on liability per loss and/or per aggregate for policy period); the period for which the policy is operative; any pending claims in the case of a

[175] See In Re Adelphia Communications Corporation v Associated Electric & Gas Insurance Services Limited.

blanket policy; whether the director in the case of a company policy has the power to enforce the insurance contract himself; the conditions and exclusions; contribution condition; outside directorships.)

(c) A contract of insurance is based upon the doctrine of utmost good faith. It is therefore critical that all relevant facts are disclosed to the insurer at the time the D&O liability policy is effected, that the insurer has correctly interpreted that information and that he has carried out adequate due diligence to ensure that there are no grounds on which the policy could be vitiated. Proper enquiries should be carried out of all relevant personnel (including directors) to ensure that this disclosure has been adequately made.

(d) The position on insolvency of the company should be checked, specifically whether the policy will automatically lapse or continue until its natural expiry.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 As mentioned in paragraph 2.2 above, legislation which would impose liability for insolvent trading has yet to be enacted in Hong Kong. In the absence of such legislation, it is not necessary for directors to analyse, when incurring credit, whether the company is insolvent and has any prospect of avoiding insolvent liquidation. Incurring credit during the twilight period is not, therefore, as hazardous as it may be in other jurisdictions, such as England. Even in the absence of insolvent trading legislation, however, directors owe duties to creditors if the company is or may become insolvent. Conceivably the incurring of further credit which cannot be satisfied in full when due and which results in an inability to satisfy the claims of other creditors in full may result in a claim by a liquidator for damages for breach of duties.

11.2 A reckless incurring of credit by directors during the twilight period, without proper consideration of the prospects of repayment in full, may lead to disqualification proceedings. In recent years, despite a significant increase in the number of liquidations, there have been relatively few disqualificationsliquidations. In the years to March 2003 and March 2004, only 41 and 32 disqualification orders respectively were made by the Hong Kong court.

In order to be free of the risk of personal liability or vulnerability to disqualification proceedings, a director should not incur credit during the twilight period unless, following proper consideration, he is satisfied that there is a reasonable prospect that the credit can be discharged when due in full. Provided that a director acts honestly and in good faith, however, in the absence of insolvent trading legislation in Hong Kong it is unlikely that the incurring of credit during the twilight period will result in personal liability of the director or in disqualification.

INDIA

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 Under Indian Law, the Sick Industrial Companies (Special Provisions) Act, 1985 (**'SICA'**) deals with re-organisation of companies and the Companies Act, 1956 (**the '1956 Act'**) provides for their liquidation. Therefore, the length of the twilight period must be considered separately in the context of each. In December 2002, the Indian Parliament passed the Companies (Second Amendment) Act, 2002 (the '**Second Amendment**') paving the way for a new insolvency regime providing for a composite law dealing with both re-organisation and liquidation proceedings. A new Part VIA was inserted in the 1956 Act and SICA was repealed. However, the Second Amendment has yet to be implemented apart from limited provisions facilitating the setting up of the National Company Law Tribunal (**the 'NCLT'**). Consequently, the repeal of SICA remains unnotified. Until the NCLT is constituted, the old regime continues in operation.

1.1.2 This chapter covers the proposed new law under the Second Amendment, although once implemented, all references in this chapter to the words "court" and "BIFR" (see below) will then have to be read as "NCLT".

1.2 Sick Industrial Companies (Special Provisions) Act, 1985 (SICA)

1.2.1 Under SICA, no definite period has been set during which transactions entered into by a company are vulnerable to attack or liable to give rise to personal liability on the part of directors and/or others involved in the management of the company. The period and liability of the Directors and other officers will vary depending upon the factors discussed below.

1.2.2 The Board of Directors of a company is required to intimate to the Board for Industrial and Financial Reconstruction (the **'BIFR'**) when 50 per cent of the company's net worth is eroded at the end of a financial year[1]. In this event, the BIFR will assume jurisdiction and will continue to have jurisdiction until (i) in cases where a scheme for rehabilitation is sanctioned, the scheme is implemented; and (ii) in cases where the BIFR forms the opinion that the company cannot be revived and it is just and equitable that it be wound up. The recommendation to wind up is sent to the High Court concerned. The twilight period could, therefore, be said to start when the net worth of the company falls below 50 per cent and comes to an end when BIFR ceases to have jurisdiction.

[1] Section 23 (1) of SICA

1.2.3 If the company fails to notify the BIFR as above, all the Directors and other officers are liable to imprisonment of not less than six months and up to two years and a fine.[2]

1.3 Companies Act, 1956 (1956 Act)

1.3.1 In a case where winding up proceedings are presented under the 1956 Act (excluding those which are taken up on the recommendation of BIFR under SICA), the twilight period during which transactions entered into by the company may be vulnerable to attack is easier to determine.

Fraudulent Preference[3]

1.3.2 Any transfer of property, movable or immovable, delivery of goods, payment, execution or other act relating to property made, taken or done by or against a company within the six months before the commencement of its winding up which, had it been made, taken or done by or against an individual within the three months before the presentation of an insolvency petition on which he is adjudged insolvent and which would be deemed in the individual's insolvency a fraudulent preference, shall be deemed a fraudulent preference and be invalid accordingly. There must have been fraudulent intent.

Formal insolvency proceedings commence when a winding up petition is admitted. Mere presentation of a winding up petition and/or notice of court to the company sought to be wound up does not constitute the initiation of winding up proceedings.

Where anything is made, taken or done which prefers a person interested in property mortgaged or charged to secure the company's debt, the person preferred is subjected to the same liabilities and rights as if he had undertaken to be personally liable as surety for the debt, to the extent of the mortgage or charge on the property or the value of his interest, whichever is less. The value of the person's interest is determined as the date of the transaction constituting the fraudulent preference and is determined as if the interest were free of all encumbrances other than those to which the mortgage or charge for the company's debt was then subject.

This provision applies, with the necessary modifications, in relation to transactions other than the payment of money as it applies in relation to payments of money.

Avoidance of voluntary transfer.[4]

1.3.3 Any transfer of property, movable or immovable, or any delivery of goods made by a company, which is not a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith, even though made for valuable consideration, shall, if made within the period of one year before the presentation of a petition for winding up by or subject to the supervision of the court or the passing of a resolution for voluntary winding up of the company, be void against the Liquidator.

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[2] Section 23(5) of SICA
[3] Section 531 of the 1956 Act
[4] Section 531A of the 1956 Act

Transfer for benefit of all creditors to be void.[5]

1.3.4 Any transfer or assignment by a company of all its property to a trustee for the benefit of all its creditors is void.

Effect of floating charge.[6]

1.3.5 Where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up is, unless it is proved that immediately after the creation of the charge the company was solvent, invalid except to the amount of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the charge, together with interest thereon.

Avoidance of transfers, etc., after commencement of voluntary winding up.

1.3.6 In the case of a voluntary winding up, any transfer of shares in the company, not being a transfer made to or with the sanction of the Liquidator, and any alteration in the status of the members of the company, made after the commencement of the winding up, shall, unless the court otherwise orders, be void.

1.4 Second Amendment

1.4.1 Part VIA of the 1956 Act[7] (the new composite insolvency regime) does not define any definite period during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company. The jurisdiction of the NCLT can be invoked for rehabilitation measures if there is erosion of 50 per cent or more of the company's average net worth at the end of a financial year during the preceding four years or when the company has failed to pay its debts on demand made in writing by the creditor(s) within any three consecutive quarters. Jurisdiction ceases upon either the successful implementation of a rehabilitation scheme, if sanctioned, or upon the winding up of the company. Therefore, the twilight period can be stated to commence on erosion of 50 per cent networth in the first of the four preceding consecutive years and to end on the restoration to 100 per cent networth or the winding up of the company. It is however, not clear whether NCLT would have jurisdiction to question transactions and actions in all the four years.

[5] Section 532 of the 1956 Act

[6] Section 534 of the 1956 Act

[7] Inserted by the Companies (Second Amendment) Act, 2002

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above: -

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

Directors may find themselves liable for acts which take place during the "twilight" period as a consequence of the specific insolvency-related offences provided for by statute or as a consequence of the general fiduciary, common law and in some cases, statutory duties imposed on a director, irrespective of the company's insolvency, but which may take on particular significance if a company finds itself in financial difficulties.

INSOLVENCY-RELATED LIABILITY

2.1 Misconduct By Officers of Companies in Liquidation[8]

2.1.1 A past or present officer of a company commits an offence if he:

(a) does not, to the best of his knowledge and belief, fully and truly discover to the Liquidator all the property, movable and immovable, of the company, how, to whom, for what consideration and when it was disposed, except where it has been disposed of in the ordinary course of business;

(b) does not deliver up to the Liquidator, or as he directs, all movable and immovable property of the company in his custody or under his control, and which he is required by law to deliver up;

[8] Section 538 of the 1956 Act

(c) does not deliver up to the Liquidator, or as he directs, all books and papers of the company in his custody or under his control and which he is required by law to deliver up;

(d) within the twelve months before the commencement of the winding up or at any time thereafter, conceals any property of the company valued at one hundred rupees or more, or conceals any debt due to or from the company;

(e) within the twelve months before the commencement of the winding up or at any time thereafter, fraudulently removes any property of the company valued at one hundred rupees or more;

(f) makes any material omission in any statement relating to the affairs of the company;

(g) fails to inform the Liquidator that a false debt has been proved by any person under the winding up;

(h) after the commencement of the winding up, prevents the production of any book or paper affecting or relating to the property or affairs of the company;

(i) within the twelve months before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies or is privy to the concealment, destruction, mutilation or falsification of any book or paper affecting or relating to, the property or affairs of the company;

(j) within the twelve months before the commencement of the winding up or at any time thereafter makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company;

(k) within the twelve months before commencement of the winding up or at any time thereafter, fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with, altering or making of any omission in, any book or paper affecting or relating to the property or affairs of the company;

(l) after the commencement of the winding up or at any meeting of the creditors of the company within the twelve months before the commencement of the winding up, attempts to account for any property of the company by fictitious losses or expenses;

(m) within the twelve months before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for;

(n) within the twelve months before the commencement of the winding up or at any time thereafter, under the pretence that the company is carrying on business, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for;

(o) within the twelve months before the commencement of the winding up or at any time thereafter, pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for unless such pawning, pledging or disposing is in the ordinary course of the business of the company; or

(p) is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them, to an agreement with reference to the affairs of the company or to the winding up.

2.1.2 If any of the above from (a)-(p) are satisfied:

(a) Liability under this provision is criminal.

(b) A person guilty of this offence is liable to imprisonment or a fine or both.

(c) The gravity of the misconduct will be reflected in the term of imprisonment or the fine imposed. In exercising its punitive jurisdiction, the court(s) do not seek to compensate the company concerned. The offence shall be punishable, in the case of any of those mentioned in sub-paras (m), (n) and (o), with imprisonment for a term of up to five years and/or a fine, and, in the case of any other offence, with imprisonment for a term of up to two years and/or a fine;

(d) The act in question must have occurred in most of the above cases either:

(i) after the commencement of the winding up; or

(ii) within the 12 months preceding the commencement of the winding up.

(e) It shall be a good defence:

(i) to a charge under (b), (c), (d), (f), (n) and (o), if the accused proves that he had no intent to defraud; and

(ii) to a charge under (a), (h), (i) and (j), if the accused proves that he had no intent to conceal the true state of affairs of the company or to defeat the law.

2.2 Defrauding Creditors[9]

2.2.1 An offence is committed by an officer of a company which is subsequently wound up by the court or which subsequently passes a resolution for voluntary winding up, if he:

(a) has, by false pretence or other fraud, induced any person to give credit to the company;

[9] Section 540 of the 1956 Act

(b) has made or caused to be made any gift or transfer of or charge on or has caused or connived at levying execution against the property of the company with intent to defraud creditors of the company; or

(c) has, with intent to defraud creditors of the company, concealed or removed any part of the property of the company since the date of any unsatisfied judgement or order for payment of money obtained against the company, or within the two months prior to that date.

2.2.2 (a) Liability under this provision is criminal. Hence, the answers to (b) and (c) are as set out in para 2.1.2 above, except that this offence is punishable with imprisonment for a term of up to two years and a fine.

(b) There is no set time period. It all depends on whether it was within the knowledge of the officer that the company was bound or likely to go into liquidation.

(c) Absence of mens rea (i.e. absence of intention to defraud) may be available as a defence.

2.3 Maintenance of Improper Accounts[10]

2.3.1 In the course of winding up of a company, if it is shown that proper books of account were not kept by the company, every officer of the company who is in default shall be guilty of the offence under this provision.

2.3.2 (a) Liability under this provision is criminal. Hence, the answers to (b) and (c) are as set out in para 2.1.2 above except that this offence is punishable with imprisonment for a term of up to one year.

(b) The offence must have been committed throughout the two years immediately preceding the commencement of the winding up, or the period between the incorporation of the company and the commencement of the winding up, whichever is shorter.

(c) It is a defence to show that he acted honestly and that, in the circumstances in which the business of the company was carried on, the default was excusable.

2.4 Falsification of Company's Books[11]

2.4.1 An offence is committed if any officer or contributory of a company, which is being wound up, with intent to defraud or deceive any person,

(a) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

(b) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company.

[10] Section 541 of the 1956 Act
[11] Section 539 of the 1956 Act

2.4.2 (a) Liability under this provision is criminal. Hence, the answers to (b and (c) are as set out in para 2.1.2 above except that this offence is punishable with imprisonment for a term of up to seven years and a fine.

(b) This offence applies when the company is being wound up.

(c) Absence of mens rea (i.e. absence of intention to defraud or deceive any person by virtue of commission of the above acts) is a defence.

2.5 Fraudulent Conduct of Company's Business[12]

2.5.1 Officers or persons are guilty of fraudulent conduct of business if, in the course of the winding up of a company, it is found that any business of the company has been carried on with intent to defraud creditors of the company or any other person, or for any fraudulent purpose. Persons engaged in the conduct of business shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company.

2.5.2 The elements of the concept are therefore:

(a) there has to be an insolvent liquidation in progress;

(b) there has to have been dishonesty in the running of the business;

(c) the standard of proof is that of 'beyond reasonable doubt', even in a case of civil liability;

(d) there is no hard and fast rule or statutory provision as to the time period within which the act or offence must have been committed. It depends on the nature and circumstances of the individual case, as scrutinised by the courts.

(e) it applies to persons who are "knowingly parties" to the fraudulent trading which may be both wider and narrower than the concept of director/shadow director for wrongful trading, but it could, in theory, be wide enough to catch a financier who funded the fraudulent trade knowing that it was being conducted dishonestly.

2.5.3 (a) Liability may be criminal or civil.

(b) The court enjoys a wide discretion to compensate for the loss caused to the company by the director's conduct but it may also include a punitive element in the award of damages made.

(c) As indicated in (ii) above, there should be an element of proportionality albeit the court's discretion is very wide.

(d) There is no specified period.

[12] Section 542 of the 1956 Act

(e) The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full.

2.6 Delinquency, Breach of Trust & Misfeasance: Directors and others[13]

2.6.1 Any person who has taken part in the promotion or formation of the company, or any past or present director, manager, Liquidator or officer of the company shall be guilty of delinquency, if he:

(a) has misapplied or retained or become liable or accountable for any money or property of the company; or

(b) has been guilty of any misfeasance or breach of trust in relation to the company;

2.6.2 (a) Liability under this provision is civil.

(b) A person guilty of this offence can be compelled by the court to repay or restore the money or property or any part thereof, with interest at such rate as the court thinks just, or to contribute such sum to the assets of the company by way of compensation for the misapplication, retainer, misfeasance or breach of trust, as the court thinks just.

(c) The court has a wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.

(d) Aside from Statute of Limitations, considerations there is no set time period within which the impugned act must have occurred in order for liability to attach. It depends on the nature and circumstances of the individual case, as scrutinised by the courts.

(e) No specific defences are provided for, although the Registrar, in making its report, will be required to give the person concerned an opportunity to state his case.

2.7 Misfeasance Proceedings[14]

2.7.1 An offence is made out, if, in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal, it appears to the BIFR that any person who has taken part in the promotion, formation or management of the company or its undertaking, including any past or present director, manager or officer or employee of the company:

(a) has misapplied or retained or become liable or accountable for any money or property of the company; or

(b) has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust in relation to the company.

[13] Section 543 of the 1956 Act

[14] Section 24 of SICA

2.7.2 (a) Liability under this provision is civil.

(b) A person guilty of this offence can be directed by the court to repay or restore the money or property or any part thereof, with or without interest, as it thinks just, or to contribute such sum to the assets of the company or to any person entitled to compensation in respect of the misapplication, retainer, misfeasance or breach of trust as the Tribunal thinks just. The Tribunal may also report the matter to the Central Government for any other action which the Government may deem fit. The officer or other person found guilty of this offence may also be prevented from borrowing any money for the next 10 years.

(c) The court has a wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.

(d) There is no time period during which the impugned act must have occurred in order for liability to attach.

(e) There is a defence if the director has acted honestly and reasonably and the court concludes that he ought fairly to be excused.

The same offence will be committed under section 424K of the 1956 Act once the Second Amendment is implemented.

2.8 Directors and Managers with unlimited liability[15]

2.8.1 In the winding up of a limited company, any director, or manager, whether past or present, whose liability is unlimited, shall, in addition, be liable to make a further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.

Exceptions:

(a) a past director or manager shall not be liable to make a further contribution if he ceased to hold office a year or more before the commencement of the winding up;

(b) a past director or manger shall not be liable to make a further contribution in respect of debts or liability of the company incurred or entered into after he ceased to hold office;

(c) subject to the articles of the company, a director, or manager shall not be liable to make such further contribution, unless the court deems it necessary to require the contribution in order to satisfy the debts and liabilities of the company, and the costs, charges and expenses of the winding up.

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[15] Section 427 of the 1956 Act

2.9 Offences under SICA[16]

2.9.1 If any person violates a Scheme sanctioned by the BIFR/AAIFR or an order passed by the BIFR/AAIFR or furnishes a false statement and/or evidence under SICA, he is liable to be punished with imprisonment for a term of up to three years and a fine.

2.10 Offences under Part VIA of the Companies Act, 1956[17]

2.10.1 Any person who violates any provision of Part VIA of the Act or any scheme or order of the NCLT or the Appellate Tribunal or who furnishes a false statement and/or evidence to the NCLT or attempts to tamper with the records of reference or appeal filed under this Act, shall be punished with imprisonment for a term of to three years and a fine.

2.10.2 The directors and other officers of every company shall ensure that books of account of the company are completed and audited up to the date of winding up order by the NCLT and submitted to it, failing which such directors and officers shall be liable for punishment for a term not exceeding one year and a fine.

GENERAL LIABILITY

2.11 Removal of Managerial Personnel[18]

If any person concerned in the conduct and management of the affairs of a company is or has been guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations or breach of trust, or the business has been conducted and managed in a manner which is likely to cause, or has caused, serious injury or damage to the interest of the trade, industry or business of the company, or with intent to defraud creditors, members or other persons, or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest, the Central Government may, in conjunction with the Company Law Board, by order, remove from office any director or other person concerned.

2.12 Reduction in membership[19]

If at any time the number of members of a company is reduced, in the case of a public company, below seven or, in the case of a private company, below two and the company carries on business for more than six months while the number is so reduced, every person who is a member of the company and knows of the fact shall be severally liable for all the debts of the company contracted during that time.

2.13 Misdescription of name[20]

In any contract of a company, if its name is not properly indicated, those responsible shall be personally liable.

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[16] Section 33 of SICA
[17] Section 424L of the 1956 Act
[18] Sections 388B, 388D & 388E of the 1956 Act
[19] Section 45 of the 1956 Act
[20] Section 147 of the 1956 Act

2.15 Fiduciary & common law duties owed to the company

Directors owe a number of fiduciary and common law duties to the company. These include:

- a duty to ensure that the corporate capital is used only for the legitimate business of the company. If any part of it has been diverted to purposes foreign to the company's memorandum, the directors will be personally liable to replace it;

- a duty to act with honesty;

- a duty to account for any profits made;

- a duty not to exploit corporate opportunities to their own advantage;

- a duty not to use the company's assets (including business connections, goodwill, trade assets and the list of customers) for the benefit of a rival concern;

- a duty to repay to the company any profit they make on shares in the company;

- a duty not to use or exploit unpublished and confidential information of the company. The company can ask the director to make good any loss arising as a result of a breach of this duty.

Once the company becomes insolvent, however, the interests of the creditors take priority. Thereafter, the directors' duties are subject to an overriding duty to have regard to the interests of the general body of creditors of the company.

2.16 Disqualification of a Director[21]

A person shall not be appointed as a director of a company, if he has been found to be of unsound mind; he is an undischarged insolvent; he has applied to be adjudicated as an insolvent and his application is pending; he has been convicted of an offence involving moral turpitude and sentenced to imprisonment for not less than six months and a period of five years has not elapsed since the expiry of the sentence; he has not paid any call in respect of shares of the company and six months have elapsed from the last day fixed for the payment of the call; or an order disqualifying him from appointment as director has been passed by the court

[21] Section 274 of the 1956 Act

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Most of the offences listed in the answer to Question 2 above, for which personal liability may be incurred, apply not only to directors but also 'officers' of the company (sometimes both past and present officers) and, in some cases, to 'managers' of the company.

3.2 A "manager" of a company means an individual (not being the managing agent) who, subject to the superintendence, control and direction of the Board of directors, has the management of the whole or substantially the whole of the affairs of the company and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not;[22]

3.3 An "officer" includes any director, manager or secretary or any person in accordance with whose directions or instructions the Board of directors or any one or more of the directors is or are accustomed to act..[23] "Secretary" means the person, if any, who is appointed to perform the duties, which may be performed by a secretary.[24]

3.4 An officer of the company (regardless of whether he is a director or not) who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise. The expression "officer who is in default" means any officer of the company who is knowingly guilty of the default, non-compliance, failure, refusal or contravention mentioned or who knowingly and wilfully authorises or permits such default, non-compliance, failure, refusal or contravention.[25]

3.5 Nominee directors**:** a nominee director is not supposed to be in charge of a company's affairs. He is not liable for failures by the company to comply with the 1956 Act or other regulatory laws. Nominee directors are mainly

[22] Section 2(24) of the 1956 Act
[23] Section 2(30) of the 1956 Act
[24] Section 2(45) of the 1956 Act
[25] Section 5 of the 1956 Act

appointed by secured creditors pursuant to the right to appoint a member on the board of funded companies. Such a nominee may be an executive of the secured creditor bank or financial institution or may sometimes be a professional. He becomes an officially appointed director and has voting rights. His main obligation is to ensure fair utilisation and application of the financial assistance lent. He also keeps an eye on the affairs though is neither responsible for nor involved in day to day affairs of the company. Since he is not involved in management, there has been a debate over the liabilities he may incur in case of fraud or wrongful action by the company. There are conflicting views of court on this issue.

A nominee director suffers from an essential conflict of duty and interest. He owes his duty to the nominator but sits on the board of the company. Problems never arise as long as the interests of the relevant companies are in harmony. But when the interests are in conflict, nominees are placed in a precarious situation.

3.6 De Facto Directors**:** a person who has acted as a director may be regarded as a director even though not validly appointed as one (for example, an executive director). To regard a person as a de facto director there must be conclusive evidence that he was the sole person directing the affairs of the company or that he acted on equal footing with other directors in managing the affairs of the company. A de facto director may be held liable for his actions during the twilight period.

QUESTION 4

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4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge, which may lead, to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Introduction

As in most legal systems, in India too, the legal position is such that it seeks to undo transactions prejudicial to a company and/or which are unfairly beneficial to a counterparty, particularly when they are entered into during the twilight period.

4.2 Summary of heads of challenge

The potential heads of challenge which may lead to transactions being set aside relate to transactions:

(a) which are at an undervalue;

(b) which are preferences;

(c) defrauding creditors;

(d) which constitute extortionate credit bargains;

(e) comprising floating charges given for past value;

(f) involving onerous property;

(g) dispositions of the company's property made after the commencement of winding-up;

(h) unregistered charges;

(i) avoidance of voluntary transfer.

4.3 Transactions at an undervalue

A transaction at an undervalue is not defined anywhere. In ordinary parlance, it could be stated to be one that is entered into at a time when the company is insolvent at an apparently lesser price than it could have attracted otherwise. There is no direct provision dealing with this aspect though it could be stated to fall under Fraudulent Preference.

Conditions for setting aside a transaction at undervalue

There are no conditions laid down in the 1956 Act, but the sale must have been made during the one-year twilight period referred to in 1.4.3.

The court may not make an order to set aside a transaction at a undervalue if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying out its business; and that at the time it did so there were reasonable grounds for believing that the transaction would benefit the company and that all possible efforts were made to get the best possible price. The court may not make an order which would prejudice purchasers in good faith and for value.

4.4 Preferences

A transaction will be a preference if it puts a creditor in a better position than he would have been in if the company had instead gone into liquidation. It is not a term defined by the 1956 Act and is not necessarily a preference made with fraudulent intent (as compared with a fraudulent preference defined by s.531 of the 1956 Act). The preference must have been made in the one-year period prior to the company's insolvency. The court has a range of options to restore the position to what it would have been if the transaction had not been entered into.

Conditions for setting aside a 'preference'

There is no specific test for what constitutes a preference. The court can, if it is satisfied on the basis of facts brought before it that a person has been preferred, make an order restoring the status quo to what it was prior to the preference having been made or direct that the person preferred shall be subject to the same liabilities and have the same rights as if he had undertaken to be personally liable as surety for the debt (if the property was mortgaged or charged to secure company's debt)

Defences

There are few reported examples of a preference. However, a court will not make an order in respect of a preference unless the company which gave the preference was influenced by a desire to prefer the person to whom the preference was given, as is the case under English law. This will be a question of fact.

4.5 Transactions defrauding creditors

Conditions

If an asset is sold with intent to put the asset beyond the reach of a person who has or may at some time make a claim against the company in respect of that asset or to otherwise prejudice the interests of that person in relation to his claim, the court can restore and protect the interests of the persons affected by the transaction.

Defences

The same defences as for transactions at an undervalue and preferences apply.

4.6 Extortionate credit transactions

Conditions

The court can set aside or vary a transaction for or involving the provision of credit to the company. It is a matter of fact and evidence.

Defences

There are no statutory defences (other than successfully to disprove the allegation).

4.7 Avoidance of floating charges for past value[26]

Where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to (i) the amount of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for the charge and (ii) interest on that amount at five per cent (or such other rate as may be notified by the central Government in the official Gazette).

Defences

It will be a defence that the company was not or did not become insolvent as a result of granting the floating charge.

4.8 Disclaimer of onerous property

4.8.1 The Liquidator may abandon onerous property belonging to the company. The following are regarded as onerous [27]

(a) land burdened with covenants;

(b) shares or stock in companies;

(c) any other property which is unsaleable or is not readily saleable by reason of the fact that it requires the possessor to perform certain acts or pay a sum of money; and

(d) unprofitable contracts.

4.8.2 The Liquidator may, with leave of the court, disclaim any such property and it is the duty of the court to help the Liquidator disclaim onerous contracts whenever this is necessary to safeguard the interests of the creditors and the shareholders of the company.

The disclaimer must be made in writing within 12 months of the commencement of the winding up or such extended period as the court may allow. The disclaimer determines in respect of the property disclaimed, the rights, liabilities and interests of the company; it releases the company and property from liability.

4.9 Disposition of the company's property made after the commencement of winding up.

Where any company is being wound up by or subject to the supervision of the court[28]

[26] Section 534 of the 1956 Act
[27] Section 535 of the 1956 Act
[28] Section 537 of the 1956 Act

(a) any attachment, distress or execution put in force, without leave of the court, against the estate or effects of the company, after the commencement of winding up; or

(b) any sale held, without the leave of the court, of any of the properties or effects of the company after the commencement of the winding up;

shall be void.

4.10 Failure to register a charge

4.10.1 The power to borrow includes the power to mortgage or charge the company's assets. Any charge created on any of the following assets of a company must be registered with the Registrar of Companies under Section 125 of the 1956 Act.

(a) a charge for the purpose of securing any issue of debentures;

(b) a charge on uncalled share capital of the company;

(c) a charge on any immovable property, wherever situate, or any interest therein;

(d) a charge on any book debts of the company;

(e) a charge, not being a pledge, on any moveable property of the company;

(f) a floating charge on the undertaking or any property of the company including stock in trade;

(g) a charge on calls made but not paid;

(h) a charge on a ship or any share in a ship;

(i) a charge on goodwill, or a patent or a licence under a patent, on a trademark, or on a copyright or a licence under a copyright.

4.10.2 A certificate is issued by the Registrar which is conclusive evidence that the requirements as to registration have been complied with. Registration must be effected within thirty days of the creation of the charge.

4.10.3 Upon registration, the charge becomes binding on the company even in its winding up and on every subsequent purchaser or incumbrancer of the property covered by the charge. The effect of non-registration is that the charge will be void against the Liquidator and any creditor of the company, in the event of a winding up.

4.11 Avoidance of voluntary transfer

4.11.1 Any transfer of property, movable or immovable, or any delivery of goods made by a company, which is not a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith, even though made for valuable consideration, shall, if made within the period of one year before the presentation of a petition for winding up by or subject to the supervision of the court or the passing of a resolution for voluntary winding up of the company, be void against the Liquidator.

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Introduction

5.1.1 When a company goes into liquidation, the authority and powers of the directors are taken over by the Official Liquidator or the Provisional Liquidator. They review actions taken by the directors and other personnel during the twilight period and if there has been any loss to the company, they try to initiate proceedings for the benefit of creditors. The Official Liquidator is in essence empowered to bring actions against the directors and others where there has been a breach of either legal or fiduciary duties owed to the company subject to the authority of the Court without the sanction of which these proceedings would have no effect.

5.2 Criminal Proceedings

5.2.1 The following acts are criminal offences which the Official Liquidator is duty bound to bring to the Court's notice

Offences

5.2.2 Fraudulent removal or concealment of property to prevent distribution among creditors and falsification of accounts are punishable under the Indian Penal Code and hence for implicating the offenders, the offences have to be brought to the notice of the Court in order to take appropriate legal action.

(a) Falsification of company's books - section 539

(b) Fraud by officers- section 540

(c) Offences by officers-section 538

(d) Fraudulent conduct of business-section 542

(e) Wrongful withholding of property-section 630

(f) False representations to creditors –section 538 (m)

(g) Disqualification of a director-section 274

5.2.3 After the notification of the Second Amendment and the Sick Industrial Companies (Special Provision) Repeal Act, 2002, the following offences will be added:

(i) Violation of provisions of Part VIA or any scheme of NCLT – Section 424L

(ii) Non-submission of audited books and accounts – Section 446A

(iii) Wilful refusal to furnish information relating to affairs of producer companies – Section 581ZM

5.2.4 The Sections referred above are sections of the 1956 Act .

5.3 CIVIL PROCEEDINGS

5.3.1 In civil proceedings, the Official Liquidator has the power to initiate action against Directors and other personnel. When certain actions cause loss to the company and its creditors, provisions provide access for a range of people to bring action to recover funds for the benefit of the company's creditors. The overall recovery so made is distributed evenly amongst the creditors in accordance to the rules relating to priority. The table below sets out those people who may bring an action against the directors and others in connection with certain transactions which the company has entered into.

Activity/transaction proceedings	**Person able to bring**
Misfeasance	Liquidator, a creditor or a contributory
Fraudulent trading	Liquidator only
Transaction at undervalue	Liquidator/Creditors
Performance	Liquidator
Extortionate credit transactions	Liquidator
Transactions defrauding creditors	Liquidator/Creditor

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

Offence	Remedy Available
Transactions in fraud of creditors	Up to five years' imprisonment and/or fine in case of falsely representing/pledging /pawning/ disposing of the company's property to obtain credit for himself. Otherwise, two years' imprisonment and/or fine.
Misconduct in winding up	Imprisonment or a fine or both.
Falsification of Company Books	Up to seven years' imprisonment and/or a fine.
Material omissions from statement relating to the company's affairs	Imprisonment which may extend to two years or a fine or both
False representations to creditors	Imprisonment for a term, which may extend to two years, and fine.
Misfeasance	A person guilty of this offence can be compelled by the Court to repay or restore the money or property or any part thereof, with interest at such rate as the Court thinks just, or to contribute to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Court thinks just.
Fiduciary Duties	Liability is civil. The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.

Offence	Remedy Available
Duties of skill and care	Liability is civil. The director may be ordered to compensate the company for all damage caused by breach of his fiduciary duty.
Fraudulent conduct of business	Up to two years' imprisonment and/or a fine.
Fraud by officers	Up to two years' imprisonment and/ or a fine.
Destroying, mutilating company documents including making an omission in a document	Liability is criminal. Imprisonment for a term which may extend to two years, or a fine, or both;
Conduct rendering a director unfit to be a director	Liability is civil.
Transactions at an undervalue and preferences	There is no specific remedy provided under the 1956 Act and/or SICA unless the transaction at an undervalue or preference is treated as an offence (delinquency, breach of trust and misfeasance) under Section 24 of SICA and Section 543 of 1956 Act (as detailed in the reply to Question No. 2), in which case an order may be made to contribute to the assets of the company by way of compensation. Such a direction can be made by BIFR/AAIFR on an application moved before it or by the Company Court as well as in a suit brought before a civil court. Once the Second Amendment comes into force, the law will be as follows: There is no specific remedy provided for unless the transaction at an undervalue or preference is treated as an offence under Section 424K and Section 543 of the 1956 Act (as amended by the Second Amendment), in which case an order may be made to contribute to the assets of the company by way of compensation. Such a direction can be made by the NCLT on an application moved before it.

Offence	Remedy Available
Transactions defrauding creditors	Liability is criminal as well as civil. An action for Criminal Breach of Trust can be brought if the transaction involved a property charged to creditors. A civil action can also be brought: for example, if a dividend is paid to shareholders but creditors are not paid despite an agreement to this effect, the creditors can bring an action.
Extortionate Credit Transactions	Liability is civil. A civil action for setting aside such transactions can be brought.
Avoidance of a floating charge	Liability is civil. The Court can declare that the floating charge is invalid in whole or in part.
Non-submission of audited books and accounts	Liability is criminal. Imprisonment for a term which may extend to one year and a fine.
Wilful refusal to furnish information relating to the affairs of producer companies	Liability is criminal. Imprisonment for a term which may extend to six months and a fine.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Obligation to co-operate with investigation into company's affairs

7.1.1 *General duty to co-operate*

(a) Under the 1956 Act and SICA officers and agents, past and present, of the company are required to co-operate with an investigation into the Company's affairs. The nature and extent of the duty to cooperate is implicit but it applies in the circumstances and is imposed on the persons set out below. Under SICA, the BIFR/AAIFR are empowered to seek information. Under the 1956 Act, the Liquidator can call for information. The duty is to give such information concerning the company and its promotion, formation, business dealings, affairs or property as may, at any time after the effective date, be reasonably required; and to attend on the BIFR/AAIFR official Liquidator at such times as they may reasonably require.

(b) After implementation of the Second Amendment, the duty to co-operate will be as before but it will be the Central Government or the NCLT[29] or the Official Liquidator[30] who can call for information.

7.1.2 The general duty to co-operate applies where:

(a) proceedings are pending before the BIFR/AAIFR under SICA, even though this is an investigation prior to the recommendation to wind up the company;

(b) a winding up petition has been presented;

(c) a provisional or Official Liquidator has been appointed;

(d) the company goes into liquidation; or

(e) a winding-up order has been made by the court.

7.1.3 The duty is imposed on:

(a) those who are or have at any time been officers of the company - this will include a director, manager or secretary of a company;

(b) those who have taken part in the formation of the company at any time during the one year before the effective date;

(c) those who are employed by the company, or have been in its employment (including employment under a contract for services - which includes those who have provided professional services to the company, for example, accountants) within the one year, and are in the official Liquidator's opinion capable of giving information which he requires;

(d) those who are, or have within that one year been, officers of, or in the employment (including employment under a contract for services) of another company which is, or within that year was, an officer of the company in question; and

[29] Sections 424J, 439A and 441E of the 1956 Act

[30] Section 454 and 457(2D) of the 1956 Act

(e) in the case of a company being wound up by the NCLT, any person who has acted as the official Liquidator or provisional Liquidator of the company.

7.1.4 *Sanction*

If any person without reasonable excuse makes default in complying with any of the requirements under section 454, he shall be punished with imprisonment for a period of up to two years and fined.

7.2 Obligation to assist with getting in the company's property[31]

7.2.1 This obligation applies where:

(a) a winding up order has been made; or

(b) a Provisional Liquidator or Official Liquidator has been appointed

The Liquidator or the provisional Liquidator is required to take into his custody or under his control, all the property, effects and actionable claims to which the company is or appears to be entitled. The directors and officers are required to hand over such property to the liquidator and assist the liquidator in obtaining possession of any property and assets not in their possession.

7.2.2 *Sanction*

The court has the power to summon any person suspected of having property of the company in their possession and may require them to produce to the court any books and papers in their custody relating to the company.[32] Failure to appear before the court may lead to their apprehension and being brought before the court for further examination.

7.3 Obligation to provide information [33]

7.3.1 The court may summon to appear before it:

(a) any officer of the company;

(b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or

(c) any person whom the court thinks is capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.

This section has very wide application.

Such persons may be required (a) to submit an affidavit to the court containing an account of their dealings with the company; or (b) to produce any books and papers in their custody or under their control relating to the

[31] Section 456 of the 1956 Act
[32] Section 477 of the 1956 Act
[33] Section 477 of the 1956 Act

company (but subject to and without prejudice to any lien that they may claim on the books or papers and the court shall have jurisdiction in the winding up to determine all questions relating to the lien).

7.3.2 *Sanctions*

If any officer or person so summoned, after being paid or tendered a reasonable sum for his expenses, fails to appear before the court at the appointed time, the court may cause him to be apprehended and brought before the court for examination.

7.4 Company's statement of affairs[34]

7.4.1 Where the court has made a winding-up order or appointed a provisional Liquidator, the official Liquidator or the provisional Liquidator may require certain persons to make out and submit to him a statement of the affairs of the company.

The persons who may be required to provide such a statement are:

(a) those who are or have been officers of the company;

(b) those who have taken part in the formation of the company at any time during one year before the relevant date;

(c) those who are in the company's employment, or have been in its employment within that year, and are, in the official Liquidator's opinion, capable of giving the information required; or

(d) those who are or have been within that year officers of, or in the employment of, a company which is, or within that year was, an officer of the company.

7.4.2 *Sanction*

Past and present officers of the company may commit an offence if they make material omissions from the statement of affairs.

If any person without reasonable excuse makes default in complying with any of the requirements under section 454, he shall be punished with imprisonment for a period of up to two years and fined.

7.5 Public examination of officers[35]

7.5.1 Where a company is being wound up by the court and the official Liquidator has made a report to the court stating that in his opinion a fraud has been committed by any person (a) in the promotion or formation of the company or (b) by any officer of the company, the court may direct the person or officer to appear before the court and be publicly examined.

[34] Section 454 of the 1956 Act
[35] Section 478 of the 1956 Act

7.5.2 *Sanction*

The court may, on proof of probable cause that a contributory is about to quit India or abscond, or avoid examination, have the contributory arrested and his books and papers and movable property seized and kept safe until such time as the court may order.[36]

7.6 Human Rights

7.6.1 In India, Human Rights are protected under the Protection of Human Rights Act, 1993. This Act was enacted to take into account gross violation of Human Rights, meaning rights related to life, liberty, equality and dignity of an individual guaranteed by the Constitution of India or embodied in the International Covenants and so enforceable in Indian Courts.

7.6.2 The Act provides for a Commission on a National and State Level, which inquires into complaints *suo moto* or on a petition presented to it by a victim or any person on his behalf. Complaints are in the nature of violation of human rights or abetment and negligence in the prevention of such a violation by a public servant.

7.6.3 Powers of Commission

The Commission has powers akin to the civil courts and can therefore:

(a) summon and enforce the attendance of witnesses and examine them on oath

(b) discover and ask for the production of any document

(c) receive evidence on affidavits

(d) requisition any public record or a copy from any court or office;

(e) issue commissions for the examination of witnesses or documents; and

(f) any other matter which may be prescribed

The Commission can conduct any investigation pertaining to an inquiry; it can also call for information from the Government or any other Authority.

7.6.4 Opportunity

It gives reasonable opportunity to people who are likely to be adversely or prejudicially affected.

7.6.5 Incriminating Statement

Statements made by persons to the Commission cannot be used against them in civil or criminal proceeding except on a prosecution for giving false evidence by such statement,

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[36] Section 479 of the 1956 Act

7.6.6 Action taken

If the inquiry discloses a Human Rights violation or negligence on part of a public servant, appropriate steps are taken in the Court of law for punishing the accused, as permitted by the law.

Proceedings in the Human Rights Court are deemed to be judicial proceedings.

QUESTION 8

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8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation Period for Criminal Proceedings

8.1.1 The position is same as under English Law viz. the general rule being that no limitation period applies to criminal proceedings unless stipulated by statute. No limitation applies to the offences attracting criminal liability, identified in the answer to Question 6. Disqualification proceedings can be initiated in civil proceedings.

8.2 Limitation Period for Civil Actions

8.2.1 Delinquency, Breach of Trust & Misfeasance: Directors and others[37]

An application under Section 543 of the 1956 Act, which is similar to Section 24 of SICA, has to be made within five years from the date of the winding up order or from the first appointment of the Liquidator or the date of the alleged offence. However, no limitation has been provided under SICA.

Following implementation of the Second Amendment, Section 24 of SICA will be repealed. However a similar provision will be added to the 1956 Act, Section 424K. As under section 24 of SICA, no limitation has been provided under section 424K of the 1956 Act.

8.3 Other Offences[38]

8.3.1 For the other offences, no specific limitation has been provided. In this event, the limitation period provided under the Limitation Act 1963 will usually apply.

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[37] Section 543 of the 1956 Act

[38] Under the 1956 Act & SICA

In relation to any suit / application for which no period of limitation is provided elsewhere under the Limitation Act 1963, the limitation period is three years and the time from which the period begins to run is when the right to sue/ apply accrues.

8.4 Appeals

(a) An Appeal against an order passed by the BIFR under Section 24 of SICA lies to the AAIFR which can be preferred within 45 days from the date of the communication of the order. The delay in filing the Appeal can be condoned if the delay is of 15 days.

(b) Most complaints for offences committed under the 1956 Act are made to the Company Law Board. An appeal against an order of the Company Law Board lies to the Company Judge of the High Court within whose jurisdiction the company is located. The Company Law Board has the same power as a Civil Court; it has no power to review its order. Orders passed by the Company Law Board are also subject to judicial review by the High Court. Any person aggrieved by any decision or order of the Company Law Board may file an appeal to the High Court on any question of law arising out of the order. There can be no appeal on a question of fact and hence the Board is the final authority so far as questions of fact are concerned. Any appeal must be filed within 60 days of the communication of the order or decision to the appellant. unless extended by the High Court for a further period of 60 days. The appeal lies before the High Court where the registered office of the company is situated and not at the place where the Company Law Board arrives at a decision.

(c) Actions before a Civil Judge/Magistrate are appealable before a District Judge. A revision also lies against the order of a Civil Judge to the High Court if the order is questioned for want of jurisdiction. The order of the District Judge can be challenged before the High Court. Orders of the High Court are final and only if leave is granted can an appeal be made to the Supreme Court of India.

8.5 After the implementation of the Second Amendment and the Repeal Act, the law relating to appeals will change. The new position will be as follows.

(i) After the commencement of the Companies (Second Amendment) Act, 2002, complaints for offences committed under the 1956 Act will lie to the National Company Law Tribunal. Any person aggrieved by any decision or order of the NCLT may file an appeal with the Appellate Tribunal provided the order or decision was not made with the consent of the parties. Any appeal must be filed within 45 days of the communication of the order or decision to the appellant, unless extended by the Appellate Tribunal. The NCLT and the Appellate Tribunal shall have the same powers as the Civil Court. Any person aggrieved by the decision or order of the Appellate Tribunal may file an appeal to the Supreme Court within 60 days of the date of communication of the decision or order of the Appellate Tribunal to him on any question of law.

(ii) Appeals from orders made or decisions given before the commencement of the Second Amendment in the matter of winding up by the Court shall lie to the same Court, in the same manner, and subject to the same conditions for an appeal from any order or decision of the Court in cases within its ordinary jurisdiction.[39]

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Introduction

9.1.1 A foreign corporation may be wound up in India as an unregistered company, provided it has established a place of business within India.[40]

9.1.2 An unregistered company includes any partnership, association or company consisting of more than seven members which is not a railway company incorporated by any Act of Parliament or other India law or any Act of Parliament of the United Kingdom, a company incorporated in India or a company registered under any previous companies law and not being a company whose registered office was in Burma, Aden or Pakistan immediately before the separation of that country from India.

9.2 Winding up of unregistered companies[41]

9.2.1 All the provisions (including those set out in Question 2) with respect to winding up of a domestic company shall apply to an unregistered company.

9.2.2 No unregistered company shall be wound up voluntarily by the court.

9.3 Criteria of winding up[42]

An unregistered company may be wound up if:

(a) the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;

(b) the company is unable to pay its debts;

(c) the court is of opinion that it is just and equitable that the company be wound up.

[39] Section 483 of the 1956 Act
[40] Section 591 of the 1956 Act
[41] Section 583 of the 1956 Act
[42] Section 583 of the 1956 Act

9.4 Record of Information

9.4.1 Foreign companies which establish a place of business within India shall, within one month of establishment, deliver to the Registrar of Companies for registration[43]:

(a) a certified copy of the charter, statutes, or memorandum and articles of the company or other instrument constituting or defining the constitution of the company; and if the instrument is not in English, a certified translation;

(b) the full address of the registered or principal office of the company;

(c) a list and details of the directors and secretary containing certain particulars;

(d) details of one or more persons authorised to accept service of documents in India on behalf of the company; and

(e) details of its principal place of business in India.

9.4.2 Every foreign company is required to:[44]

(a) prepare an annual balance-sheet and profit and loss account as if it were a domestic company; and

(b) deliver copies to the Registrar.

9.5 Penalties:[45]

If a foreign company fails to comply with any of the foregoing provisions, every officer or agent of the company who is in default shall be punishable by a fine of up to one thousand rupees, and in the case of a continuing offence, by an additional fine of up to one hundred rupees for every day the default continues.

9.6 Effect of Offence:[46]

Any failure by a foreign company to comply with any of the foregoing provisions shall not affect the validity of any contract, dealing or transaction entered into by the company or its liability to be sued in respect thereof.

But the company shall not be entitled to bring any suit, claim any set-off, make any counter-claim or institute any legal proceeding in respect of the contract dealing or transaction until the foregoing provisions have been complied with.

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[43] Section 592 of the 1956 Act
[44] Section 594 of the 1956 Act
[45] Section 598 of the 1956 Act
[46] Section 599 of the 1956 Act

9.7 Miscellaneous Provisions:

Apart from the above, the provisions pertaining to the registration of charges, appointment of receiver and books of account as applicable to the domestic companies shall apply mutatis mutandis to the foreign companies as well.

QUESTION 10

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10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 There is no provision under Indian Law, statutory or otherwise providing for this and hence directors' and officers' insurance is not available in India.

QUESTION 11

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11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 Overview

(a) In India, when a rehabilitation scheme for revival of an insolvent company is under consideration, it may contemplate fresh financial assistance and/or additional financial burden by way of interest on deferred/re-scheduled payments. The earlier credits continue but they are part of the rehabilitation scheme. Under the provisions of SICA, every scheme for rehabilitation is monitored by an agency appointed by the BIFR. The responsibility of directors is much higher during this period in respect of further credit as there is direct supervision by the BIFR and the liabilities are much more serious. Although there are very few instances where the directors have been penalised by being directed to restore the property or money or make good the loss, there have been cases where observations have been made against the directors by BIFR which have had the consequence of informally blacklisting the directors and the companies in which they are directors from further financial assistance in future.

(b) The court is empowered to injunct the directors from dealing with and/or disposing of assets during insolvency proceedings except in the ordinary course of business. Normally courts issue such directions at the instance of creditors. However, during the period when a rehabilitation scheme is under implementation, such a direction may not be given. Directors must, however, have regard to the interests of creditors as not only will the creditors' approval to the rehabilitation scheme be required but also the directors may otherwise expose themselves to liability for serious misfeasance, mal-feasance and non-feasance.

(c) How well the interests of creditors are protected in practice is, perhaps, debatable. There is a general feeling that directors escape responsibility by seeking protection under SICA and get away without paying creditors for years whilst continuing to enjoy possession and use of the assets.

11.2 Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period?

(a) As is the situation in most of the legal systems all over the world, in India too, the period preceding the commencement of insolvency proceedings is vulnerable. Under Indian Law, every transaction in the one year preceding the presentation of insolvency proceedings may be subject to challenge pursuant to the provisions of the 1956 Act.

(b) Under SICA, the creditors can question transactions of the company while its accounts and financial affairs are being scrutinised for determining whether it has become insolvent. While the High court has the power to set aside such transactions, the BIFR can only make observations and consider reverse entries by taking into account the loss that may have occurred due to undervalue sale or under-invoicing etc. The creditors and shareholders can always challenge a transaction of the company or an act of breach of duty by a director.

(c) There are no means whereby a potential buyer wishing to buy assets from a Company facing insolvency can know that a Liquidator will try and seek to set the transaction aside later. While scrutinising the accounts, if the Liquidator feels that a particular transaction was glaringly undervalued and thus, questionable, it could become subject to setting aside proceedings. Obviously, once it is definitely concluded that the sale was not bona fide and that it highly undervalued the company's interest, it will be set aside. The property would be put to resale. The buyer or person in possession would be given the first preference to repurchase the asset if he were able to meet the market value.

(d) It is advisable to obtain proper professional advice before entering into any transaction. The solution could be to obtain an Indemnity Bond indemnifying against future loss should the transaction be set aside.

(e) Sometimes a creditor also uses its position to coerce the company to enter into a transaction with it to sell a property at a much lower price than the market value. The other creditors will find themselves in a dilemma particularly if the creditor, who has entered into a transaction, has very high stakes and has a charge over the assets of the company and has first preference in terms of repayment of debt. Thus, the third parties are always at risk. Even those assets, which are sold by way of a court sale, can become the subject matter of litigation for many years.

APPENDIX

1. INSOLVENCY PROCEDURE

1.1 Who can wind up a Company?

1.1.1 The winding up of a company may be by the court or voluntary or subject to the supervision of the court.[47]

1.1.2 Predominantly, we are here concerned with a winding up by NCLT, as only the court can wind up a Company for insolvency

1.2 Winding up by the court

1.2.1 A company may be wound up by the court if:[48]

(a) the company has resolved that it be wound up by the court;

(b) the company fails to file the statutory report with the Registrar of Companies;

(c) the company fails to hold its statutory meeting;

(d) the company fails to commence its business within a year from incorporation;

(e) the company suspends its business for a whole year;

(f) the number of members is reduced, in the case of a public company, below seven, and in the case of a private company, below two;

(g) the company is unable (or deemed unable) to pay its debts;

(h) the court finds it just and equitable to wind up the company;

(i) the company has made a default in filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years;

(j) the company has acted against the interests of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality, (on an application made by the Central or State Government);

(k) the NCLT is of the opinion that the company should be wound up under the circumstances specified in section 424G; or

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47 Section 425 of the 1956 Act
48 Section 433 of the 1956 Act

(l) the NCLT is satisfied that a compromise or an arrangement sanctioned under section 391 of the 1956 Act cannot be worked satisfactorily with or without modifications.

1.2.2 A company shall be deemed unable to pay its debts[49]:

(a) if the company after having received a formal written demand notice from its creditor has neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor;

(b) if execution or other process issued on a decree or order of any Court in favour of a creditor of the company is returned unsatisfied in whole or in part; or

(c) if it is proved to the satisfaction of the Court that the company is unable to pay its debts.[50]

1.3 Procedure for Petitioning -

1.3.1 [51]An application to the court for the winding up of a company shall be by petition presented by the company or by any creditor or creditors, including any contingent or prospective creditor or creditors or by any contributory or contributories or by the Registrar of Companies. In certain cases of mismanagement, statutory violations etc., any person authorised by the Central Government can also petition for winding up.

1.4 Voluntary Winding up

1.4.1 Where a company is being wound up voluntarily, a petition for its winding up by the court may be presented by any person authorised to do so under the preceding head of 'Procedure for Petitioning' or the Official Liquidator.[52]

1.5 Commencement of winding up by the Court[53]

(a) In the case of a voluntary winding up: where, before the presentation of a petition for the winding up of a company by the court, a resolution has been passed by the company for a voluntary winding up, the winding up of the company shall be deemed to have commenced at the time of the passing of the resolution.[54]

(b) In any other case: the winding up of a company by the court shall be deemed to commence at the time of the presentation of the petition for the winding up.

[49] Section 434 of the 1956 Act

[50] In determining whether a company is unable to pay its debts, the Court shall take into account the contingent and prospective liabilities of the company.

[51] Section 439 of the 1956 Act

[52] The Court shall not make a winding up order on a petition presented to it unless it is satisfied that the voluntary winding up cannot be continued with due regard to the interests of the creditors or contributories or both.

[53] Section 441 of the 1956 Act

[54] Unless the court, on proof of fraud or mistake, thinks fit to direct otherwise, all proceedings taken in the voluntary winding up shall be deemed to have been validly taken.

1.6 Powers of Winding up Court[55] -

1.6.1 On hearing a winding up petition, the court may:

(a) dismiss it, with or without costs;

(b) adjourn the hearing conditionally or unconditionally;

(c) make any interim order that it thinks fit; or

(d) make an order for winding up the company with or without costs, or any other order that it thinks fit.

1.6.2 At any time after the presentation of a winding up petition and before the making of a winding up order, the court, may appoint the Official Liquidator[56] as provisional liquidator.

1.7 Consequences of winding up order-

1.7.1 Where the court makes an order for the winding up of a company, the same is conveyed forthwith to the Official Liquidator[57] and the Registrar of Companies.

1.7.2 The winding up order is made public and the officers and employees of the company are discharged, except when the business of the company is continued.

1.7.3 When a winding up order has been made or the Official Liquidator has been appointed as provisional liquidator, no suit or other legal proceeding shall be commenced, or if pending at the date of the winding up order, shall be proceeded with, against the company except by leave of the court and subject to such terms as the court may impose.

1.7.4 Soon after the winding up order, the Official Liquidator shall submit to the court a detailed statement of affairs covering the amount of the company's capital issued, subscribed, and paid up, the estimated amount of assets and liabilities, cash and negotiable securities, debts due from contributories, debts due to the company and any securities in respect of such debts, movable and immovable properties belonging to the company and unpaid calls.

1.7.5 Where a winding up order has been made or where a provisional liquidator has been appointed, the liquidator shall take into his custody or under his control, all the property effects and actionable claims to which the company is or appears to be entitled.

1.7.6 All the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding up of the company.

1.7.7 The liquidator shall convene separate meetings of creditors and contributories for the appointment of committee of inspection to act with the liquidator. A committee of inspection shall consist of members, being creditors and contributories of the company. The committee of inspection shall have the right to inspect the accounts of the liquidator at all reasonable times.

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[55] Section 443 of the 1956 Act

[56] The Official Liquidator is a full-time officer appointed by the Central Government and attached to the court.

[57] On a winding up order being made in respect of a company, the Official Liquidator shall, by virtue of his office, become the liquidator of the company.

1.7.8 As soon as possible after making a winding up order, the court shall settle a list of contributories and cause the assets of the company to be collected and applied in discharge of its liabilities.

1.7.9 The court may, at any time after making a winding up order, require any contributory and any trustee, receiver, banker, agent, or officer of the company, to pay, deliver, surrender or transfer forthwith, or within such time as the court directs, to the liquidator, any money, property or books and papers in his hands to which the company is prima facie entitled.

1.7.10 When an order has been made for winding up a company by the court, and the Official Liquidator has made a report to the court under this Act, stating that in his opinion a fraud has been committed by any person in the promotion or formation of the company, or by any officer of the company in relation to the company since its formation, the court may publicly examine the person(s) concerned as to the promotion or formation or the conduct of the business of the company, or as to that person's conduct and dealings as an officer thereof.

1.8 Effect of winding up order-[58]

1.8.1 An order for winding up a company shall operate in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of a contributory.

1.9 Liability

1.9.1 As contributories of present and past members:- in the event of a company being wound up, every present and past member shall be liable to contribute to the assets of the company an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of the winding up.[59]

1.9.2 As directors and managers[60]:- in the winding up of a limited company, any director, secretary and treasurer or manager, whether past or present, whose liability is unlimited shall, in addition to his liability, if any, to contribute as an ordinary member, be liable to make a further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.[61]

1.10 Dissolution of company[62]**-**

1.10.1 When the affairs of a company have been completely wound up, the court shall make an order that the company be dissolved from the date of the order, and the company shall be dissolved accordingly.

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58 Section 447 of the 1956 Act

59 Section 426 of the 1956 Act

60 Section 427 of the 1956 Act

61 A past director, secretary and treasurer or manager shall not be liable to make such further contribution, if he has ceased to hold office for a year or more before the commencement of the winding up. A past director, managing agent, secretary and treasurer or manager shall not be liable to make such further contribution in respect of any debt or liability of the company contracted after he ceased to hold office.

62 Section 481 of the 1956 Act

ITALY

QUESTION 1

1 The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Foreword

1.1.1 Corporations in the twilight period are governed both by insolvency law rules and by company law rules.

1.1.2 In 2003, the Italian Government enacted a sweeping company law reform which came into force on January 1, 2004[1]. The new company law fails to co-ordinate its provisions with Italian bankruptcy law (which dates back to 1942), because a comprehensive bankruptcy law reform is expected in the near future. In the meantime and in the absence of any meaningful case law thus far, most legal issues involving corporations in the twilight period are the subject of hot debate among legal scholars. In dealing with company law issues, therefore, this chapter will provide an account of the prevailing scholarly interpretations of the new rules and of the case law developed under the previous regime where the new rules are identical or similar to the old ones. It is uncertain whether the courts will confirm their prior findings under the new law or follow the prevailing scholarly interpretations.

1.1.2.1 Unless otherwise specified, the description of relevant Italian law provisions below applies to all companies, whether stock corporations (*società per azioni*, hereinafter SpA) or limited corporations (*società a responsabilità limitata*, hereinafter SRL).

1.1.2.2 Under the new company law, SpA may opt for one of three corporate governance systems:

- the so-called traditional one, in which alongside the board of directors (or a single director) there exists a separate board of auditors (*collegio sindacale*) with audit and monitoring functions;
- the two-tier one, whereby members of the management board are appointed by a supervisory board, which also performs audit and monitoring functions;
- the one-tier one, whereby audit and monitoring functions are exercised by an audit committee composed by independent members of the board of directors.

[1] Legislative Decree No. 6 of January 17, 2003.

1.1.3 Unless otherwise specified, by the term 'directors' reference herein relates exclusively to members of the board of directors (in the traditional and one-tier governance systems) or the management board (in the two-tier system). The liability of members of the board of auditors and of the supervisory board will be treated under 3.3 and 3.4 below.

1.1.3.1 The board of auditors is mandatory in SRL only when the company's capital is 120,000 euro or higher or when the company's size exceeds certain thresholds.[2] The board of auditors in SRL has the same powers and duties as boards of auditors in SpA.

1.1.4 The Bankruptcy Law[3], which dates back more than 60 years, is the main piece of legislation dealing with ordinary bankruptcy proceedings (*fallimento*) in Italy, as well as proceedings aimed at avoiding bankruptcy through a composition with creditors (*concordato preventivo*) or through a judicial moratorium (*amministrazione controllata*). The framework rules set forth by the Bankruptcy Law also apply - with certain exceptions - to special insolvency proceedings applicable to banks and insurance and investment companies (*liquidazione coatta amministrativa*).

1.1.4.1 The Bankruptcy Law, however, does not provide for reorganization procedures, which over time became increasingly necessary in the Italian economic environment, in particular for large industrial companies. For this reason, in 1979 the Italian Parliament enacted a law,[4] subsequently amended in 1999[5] (the so-called "Prodi Law"), which introduced a new insolvency procedure aimed at the reorganization of certain large insolvent companies (*amministrazione straordinaria*). In December 2003, in the wake of the Parmalat crisis, the Prodi Law was further amended and supplemented, in order to make a new specific procedure of *amministrazione straordinaria* available to particularly large and indebted companies, providing for a two-year restructuring plan and a special composition with creditors.[6]

1.2 The start and duration of the "twilight period" with respect to directors' liability

1.2.1 The law does not specifically determine the duration of the period during which directors' actions or omissions are liable to give rise to personal liability. In other words, there is no precisely defined "twilight period" with respect to directors' liability.

1.2.2 However, when a company is insolvent, directors have a duty to petition the court for an insolvency ruling. If they fail to do so and consequently aggravate the company's deficit, then they are criminally liable[7] (see 2.4.3) and may hence be held liable for the difference between the net assets at the time the company has become insolvent and the net assets as determined by the bankruptcy trustee under the bankruptcy proceedings.

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2 Article 2477, Civil Code.

3 Royal Decree No. 267 of March 16, 1942.

4 Law No. 95 of April 3, 1979.

5 Legislative Decree No. 270 of July 8, 1999.

6 Decree-law No. 347 of December 23, 2003, ratified and amended by the Italian Parliament with Law No. 39 of February 18, 2004, and further amended by Decree-law No. 119 of May 3, 2004, ratified and amended by the Italian Parliament with Law No. 166 of July 5, 2004.

7 Article 218, Bankruptcy Law

1.2.3 With regard to directors' liability, the twilight period ends when the bankruptcy trustee takes charge of the company's operations.

1.3 The start and duration of the "twilight period" under bankruptcy laws: the notion of insolvency and claw-back provisions

1.3.1 For purposes of assessing the vulnerability of transactions to attack (as opposed to the personal liability of directors), the twilight period is the period prior to the opening of a formal bankruptcy proceedings (*fallimento*),[8] during which certain transactions entered into by a company may be voided by a judgment of the court having jurisdiction over bankruptcy proceedings upon request of the bankruptcy trustee (the so called "*periodo sospetto*", or suspect period).

1.3.2 A company (or any other business enterprise) shall enter into bankruptcy proceedings when it becomes insolvent. "*Insolvency*", under Italian law, is defined as the inability of the company to regularly pay its obligations as they become due. Failing to meet payments is usually considered *prima facie* evidence of insolvency, even though obligations regularly honored may also be evidence of the company's insolvency, if such payments are made by fraudulent or detrimental means (e.g., the sale of all or part of the debtor's assets or estate on favorable terms).[9] In an insolvency situation, the company's directors, any of the company's creditors or the Public Prosecutor may file a petition in order to obtain a formal declaration of insolvency by the competent court thereby starting a formal bankruptcy procedure.

1.3.3 The date on which the suspect period is deemed to begin depends upon the different types of transactions carried out by the company prior to the opening of formal bankruptcy proceedings (or, in the case of *amministrazione straordinaria*, prior to the declaration of insolvency). Generally, such period may not exceed two years prior to that date (see question 4). Certain acts, however, may be voided even before the suspect period commences and irrespective of the fact that the company is insolvent, if specific requirements are satisfied (see question 4).

1.3.4 The suspect period ends on the date on which the competent court orders the opening of formal bankruptcy proceedings.

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[8] The same rules basically apply in the case of liquidazione coatta amministrativa (forced administrative dissolution) and in the case of amministrazione straordinaria (extraordinary administration).

[9] Article 5, paragraph 2, Bankruptcy Law. According to case law, a company is insolvent, *inter alia*, if it faces unfavorable conditions of liquidity, irrespective of the ratio of assets to liabilities, or if it has insufficient cash flow to meet its current obligations in spite of positive net assets (e.g., due to illiquid investments). Likewise, a company may be insolvent, despite having large inventories, if its goods are not saleable under standard conditions without resorting to selling below cost, or if the company faces unfavorable terms of access to credit due to its particular situation or general market conditions.

QUESTION 2

2 Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:

(i) is any resulting liability against a director civil, criminal or both?

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?

(iii) will liability attach to individual directors in proportion to their specific involvement?

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?

(v) what defences, if any, will be available in relation to each offence?

2.1. General

2.1.1 In the case of an insolvency proceeding, directors may be held liable for any act or omission in violation of their duties, as defined by the law and by the corporate by-laws, whenever such act or omission causes damage to the corporation and/or its creditors.

2.1.2 Some acts and omissions, as identified in 2.4, give rise to both civil and criminal liabilities.

2.1.3 The liability attaches jointly and severally to all directors which are held to have violated their duties. Under general principles of Italian law, the director who has refunded the damage has recourse against each of the other directors who are also at fault in proportion to the degree of fault of each and to the harmful consequences arising therefrom.

2.1.4 As explained under 1.2.1 above, there is no specified period before commencement of an insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director (see also 8.1).

2.1.5 As a general rule, there has to be a causal link between a directors' violation and the creditors' loss. Both the damage and the causal link have to be proven by the plaintiff.

2.2 Directors' duties

2.2.1 Directors owe the corporation a general duty of due care and diligence.[10] No matter whether executive or non-executive, directors of SpA must act in an informed way[11] and are liable to the corporation if, being aware of acts damaging the corporation, they fail to do what is in their power to avoid or reduce such acts' harmful consequences.[12]

2.2.2 Normally, an SpA non-executive director will comply with such duty if he acts in order to have a meeting of the board of directors called without delay, so that the board can do whatever is needed to avoid or reduce the damage following the harmful act.

2.2.2.1 Audit committees under the one-tier corporate governance system also have the power to file a complaint with the court alleging that other directors have violated their duties and that the company may suffer damage therefrom. The court may then order an inspection and, if the irregularities are found, it may order provisional measures and call the general meeting for the consequent resolutions or, in the most serious cases, remove the directors and appoint a judicial administrator.[13]

2.2.2.2 Listed companies' audit committees under the one-tier corporate governance system have a similar duty to report to CONSOB (the Italian Securities and Exchange Commission) any irregularities in the management of the company.[14]

2.2.2.3 Therefore, audit committee members who, being aware of acts damaging the corporations taken by executive directors in violation of their duties, omit to file the complaint mentioned above under 2.2.2.1 or to report irregularities to CONSOB will probably be held liable for breach of their duty to do what is in their power to avoid or reduce the damage following the harmful act.

2.2.3 In general, SpA non-executive directors carry no liability for damages following acts or omissions relating to the exercise of powers formally or *de facto* delegated to the executive committee or to one or more executive directors.[15]

2.2.4 Specific duties attach to members of the audit committee under the one-tier corporate governance system. The audit committee must verify the adequacy of the company's organizational structure, internal control system and management and accounting system. It must also perform the additional tasks assigned to it by the board of directors, with special reference to relations with the company's auditor.[16]

2.2.5 SpA directors are also directly liable toward creditors if they fail to comply with their duties concerning the preservation of the company's assets.[17]

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[10] Article 2392, Civil Code.
[11] Article 2381, Civil Code.
[12] Article 2392, Civil Code.
[13] Article 2409, Civil Code.
[14] Article 149, paragraph 4-ter, Legislative Decree No. 58 of February 25, 1998.
[15] Article 2392, Civil Code.
[16] Article 2409-octiesdecies, Civil Code.
[17] Article 2394, Civil Code.

This expression covers all directors' duties which are liable to have an impact upon the company's solvency, such as rules on distributions to shareholders, the formation of capital, the drawing of annual accounts, the issue of bonds, and so on.

2.2.6 No rule such as the one described under 2.2.5 exists for SRL. Therefore, corporate law scholars currently debate whether SRL directors are also liable to creditors if they fail to comply with the similar duties concerning the preservation of the company's assets existing also for SRL or whether liability can otherwise be derived from general tort law or company law principles.

2.2.7 In application of general tort principles, directors are liable together with the corporation to shareholders and third parties whom they directly (i.e., in the case of the former, not *qua* shareholders) harm while performing their duties.[18] So, for instance, directors issuing false accounting statements may be held liable toward shareholders who acquired shares relying upon such statements.

2.3 Directors' duties in the event of a company's dissolution

2.3.1 Specific liability provisions apply in the case of a company's dissolution. Such provisions are worth discussing, because one of the events of dissolution as indicated by the law frequently occurs before or at the time a company becomes insolvent: the one connected with the so-called "recapitalize or liquidate rule".

2.3.2 Before describing this rule, it is worth recalling that, when an event of dissolution occurs,[19] directors have a duty to inform the general public without delay that the company is dissolved by way of a notice to be deposited at the Companies Register. If they fail to do so, they are liable to the company, its shareholders, creditors and other third parties for damages.[20]

2.3.3 Upon the occurrence of an event of dissolution and until liquidators are appointed,[21] directors may manage the company for the sole purpose of preserving the integrity and value of corporate assets. Directors are personally and jointly liable for the damages caused to the company, its shareholders, creditors and third parties for breach of such a provision, i.e. for entering into transactions with a purpose other than the preservation of the integrity and value of corporate assets.[22] It is hard to predict what kind of transactions may fall under this provision, which has been introduced by the 2003 company law reform. Arguably, high-risk transactions or transactions which imply a material increase in the exposure of the company may fall within its scope.

[18] Article 2395, Civil Code.

[19] Relevant events of dissolution are the following (Article 2484, Civil Code): (i) impossibility to function or protracted inactivity of the shareholders meeting; (ii) reduction of capital below the minimum required by law, unless the company is recapitalized or converted into another company (see text below, 2.3.4); (iii) resolution of the shareholders meeting; (iv) other events identified in the by-laws.

[20] Article 2484, Civil Code.

[21] See below, 3.2.1.

[22] Article 2485, Civil Code.

2.3.4 According to the recapitalize or liquidate rule, if a company's net assets fall both below two-thirds of the stated capital and below the minimum capital as prescribed by the law (€120,000 for SpA; €10,000 for SRL), directors must call a general meeting without delay. The general meeting has to decide whether to reduce the capital and increase it to an amount not less than the statutory minimum or whether to convert the company into an SRL (provided that the SpA still has net assets, or shareholders contribute assets worth, at least €10,000) or into a partnership. Unless either measure is taken, the company dissolves.[23]

2.3.5 This rule predates the recent company law reform. According to the case law developed under the previous regime, directors have an ongoing duty to control the company's accounts to monitor whether net assets fall below these thresholds. This implies that directors breach the recapitalize or liquidate rule if, during the financial year, they wilfully or negligently fail to acknowledge that net assets have fallen below the specified thresholds and hence do not call the shareholders meeting.

2.3.6 Failure to act by the general meeting when net assets have fallen below these thresholds is an event of dissolution. In practice, it often happens that companies are declared insolvent well after such an event of dissolution has occurred. When this is the case, the directors' actions and omissions subsequent to the time when a diligent director would have taken the steps required by the recapitalize or liquidate rule shall all be reviewed by the court in light of the requirement that directors act with the sole purpose of maintaining the integrity and the value of the corporate assets.

2.4 Facts giving rise to both criminal and civil liability

2.4.1 Italian law provides for specific felonies resulting from actions carried out by the company's representatives in the period immediately preceding the declaration of bankruptcy or during the bankruptcy proceedings.

2.4.2 The most relevant felonies punished by the Bankruptcy Law are criminal bankruptcy (*bancarotta semplice*) and fraudulent bankruptcy (*bancarotta fraudolenta*). The prerequisite for both of these offences is that the company is declared bankrupt.[24]

2.4.3 Criminal Bankruptcy (*Bancarotta semplice*) [25]

2.4.3.1 This criminal offence is committed when a director, with wilful misconduct or gross negligence:

(i) has wasted or contributed to waste a significant part of the company's assets in hazardous or openly irresponsible transactions;

(ii) has carried out or contributed to carry out highly imprudent operations, with the intention to delay bankruptcy proceedings;

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[23] Articles 2447, 2482-ter, and 2484, No. 4), Civil Code.

[24] The same rules apply in the case of the so-called *concordato preventivo* (composition with creditors) and in the case of *amministrazione controllata* (supervised management), as well as, upon declaration of insolvency, in the case of *liquidazione coatta amministrativa* (forced administrative dissolution) and in the case of *amministrazione straordinaria* (extraordinary administration).

[25] Articles 217 and 224, Bankruptcy Law.

(iii) has worsened or contributed to worsen the financial distress of the company, by delaying to file the request of declaration of bankruptcy, or by committing another act of gross negligence;

(iv) has not fulfilled the obligations undertaken pursuant to a composition with creditors carried out in order to avoid bankruptcy (*concordato preventivo*) or to end the bankruptcy proceedings (*concordato fallimentare*); or

(v) in the three years preceding the bankruptcy declaration, has kept (or has contributed to keeping) manifestly incomplete accounting books and other accounting records or has kept accounting books and other accounting records that do not comply with the applicable legal requirements; and

(vi) by committing any of the acts under (i) to (v) above, has contributed to worsen the financial conditions of the company by disregarding the duties specifically imposed on him by the law.

2.4.3.2 A person found liable of *bancarotta semplice* is sanctioned with imprisonment for a term ranging from six months to two years, and with the prohibition to conduct business activities and to assume executive positions in any company or commercial undertaking for a period of up to two years. Further collateral sanctions may apply, based on general criminal law rules.

2.4. Fraudulent Bankruptcy (*Bancarotta fraudolenta*)[26]

2.4.4.1 This criminal offence is committed when a director, with wilful misconduct:

(i) before the declaration of bankruptcy or during the bankruptcy proceedings, has fraudulently misappropriated, concealed, destroyed or dissipated the company's assets, in whole or in part, or has fraudulently acknowledged and accepted non-existent debts in order to damage the company's creditors;

(ii) before the declaration of bankruptcy, has concealed, destroyed or falsified, in whole or in part, the company's accounting books or other accounting records, in order to gain an unlawful profit (also in the interest of a third party) or in order to damage the company's creditors, or has kept the company's books and accounting records in a manner that makes it impossible to reconstruct the company's assets or business operations;

(iii) during the bankruptcy proceedings, destroyed, concealed, or falsified the company's books and other accounting records;

(iv) before the declaration of bankruptcy or during the bankruptcy proceedings, has effected payments or simulated priority rights, in order to favour certain creditors of the company;

[26] Articles 216 and 223, Bankruptcy Law.

(v) before the declaration of bankruptcy has worsened or contributed to worsen the financial conditions of the company by committing one of the following crimes: (i) false corporate declarations[27]; (ii) false corporate declarations causing damages to the company's shareholders or creditors[28]; (iii) unlawful refunds of capital contributions to shareholders[29]; (iv) unlawful distribution of profits and corporate reserves[30]; (v) operations prejudicing the company's creditors[31]; (vi) formation of a fictitious share capital[32]; (vii) unlawful distribution of company's assets by liquidators[33]; (viii) unlawful disposal of corporate assets[34]; or

(vi) has caused with wilful misconduct, or as a result of transactions carried out with wilful misconduct, the bankruptcy of the company.

2.4.4.2 A person found liable of *bancarotta fraudolenta* is sanctioned with imprisonment for a term ranging from three to ten years (except for (iv) above, which is one to five years), and with the prohibition to conduct business activities and to assume executive positions in any company or commercial undertaking for a period of ten years. Further collateral sanctions may apply, based on general criminal law rules.

2.5 Extent of directors' liability for damages

2.5.1 In principle, no provision either in the new company law or in the insolvency laws makes directors liable to creditors in respect of the whole deficit and no such rule can be derived from general principles on breach of contract, torts or directors' duties toward creditors.

2.5.2 However, the Supreme Court (*Corte di Cassazione*) has repeatedly held that, when a causal link can be found between the violation of directors' duties, primarily their duties under the recapitalize or liquidate rule or those arising once an event of dissolution occurs (see 2.3 above) and the deficit to creditors (or in one Court's ruling, the company's insolvency), the directors are liable for the entire deficit.

2.5.3 Prior to the recent company law reform, in the light of a now-repealed rule under which directors were forbidden to "engage in new transactions" once the company was dissolved, some courts held directors liable for any deficit accumulated after dissolution. Under the new regime (see 2.3.2 and 2.3.3 above), directors will possibly be held liable for the whole deficit accumulated in connection with acts or omissions taken with purposes other than the preservation of the integrity and value of corporate assets. It is too early to say whether judges may construe this formula broadly and hold that after an event of dissolution the continuation of the company's business is *per se* inconsistent with those purposes.

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[27] Article 2621, Civil Code
[28] Article 2622, Civil Code
[29] Article 2626, Civil Code
[30] Article 2627, Civil Code
[31] Article 2628, Civil Code
[32] Article 2632, Civil Code
[33] Article 2633, Civil Code
[34] Article 2634, Civil Code

2.5.4 Courts have consistently held that the deficit to creditors is no cap to directors' liability, i.e. that they may be held liable for further damages, if the plaintiff provides evidence thereof. This is because in an insolvency proceeding the liquidator may also bring suit against directors for damages suffered by the corporation, i.e. by shareholders *qua* shareholders.

2.5.6 Courts have also held directors liable to creditors in respect of the whole deficit in cases in which directors had completely omitted to keep the company's books.

2.5.7 See also above under 1.2.2 for the extent of directors' liability in the event of violation of the duty to petition the court for an insolvency ruling.

2.6 Defences

2.6.1 The following are the most common defences to which directors resort in liability suits brought by the insolvency liquidator:

- Non-executive directors may argue that harmful acts were taken by executive directors within the scope of their delegated power (see 2.2.2). Once this is proven, the issue becomes whether non-executive directors knew or should have known in light of their general duty of due care and diligence that harmful acts had occurred and whether they failed to do what was in their power to avoid or reduce the consequences.

- Statute of limitations (see infra, 8.1).

- Absence of causal link between the violation and the damage suffered by the corporation and/or its creditors.

2.6.2 The courts have consistently held that it is irrelevant whether certain acts or transactions had been authorized by shareholders.

2.6.3 According to a new provision in the Civil Code, liability does not extend to the SRL directors who prove that they:

(i) exercised due care and diligence; and

(ii) expressed their dissent after knowing that a harmful action was about to be taken.[35]

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[35] Article 2476, Civil Code.

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 General Manager

3.1.1 Italian companies usually appoint a general manager/chief operating officer (*direttore generale*), who may or may not be also a member of the board. General managers are liable to the corporation, its creditors and third parties under the same rules on directors. Liability, however, only covers violations relating to the general managers' tasks as defined by the act of appointment or by the by-laws.

3.1.2 Like directors (see above 2.2.7), general managers may be held liable to shareholders and third parties according to general tort law principles.

3.1.3 Like directors (see above 2.4), general managers may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.1.4 It is debated whether other top officers (such as chief financial officers) shall be deemed subject to the liability regime applicable to general managers.

3.2 Company liquidators

3.2.1 When a company is dissolved, the general meeting or the court in case of inertia of the former appoint one or more liquidators, whose task it is to sell the company's assets, whether as a going concern or piecemeal, pay creditors and distribute any further proceeds to shareholders. A company may of course enter insolvency proceedings after liquidators have been appointed, in which case the bankruptcy trustee may also sue the liquidators for damages.

3.2.2 Liquidators must perform their duties with the professionalism and care required by the nature of their office. Rules on directors' liability equally apply to liquidators who have acted in breach of their duties.[36]

3.2.3 Like directors (see above 2.4), liquidators may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.3 Members of the board of auditors

3.3.1 The board of auditors in companies who have opted for the traditional corporate governance system has a duty to verify: (i) directors' and managers' compliance with the law, the by-laws and principles of correct management; (ii) the adequacy of the organizational, administrative and accounting arrangements adopted by the company and the actual operation thereof.

3.3.1.1 In closely-held SpA which are under no obligation to draw consolidated accounts, it may also audit the company's accounts, if the by-laws so provide. In SRL for which a board of auditors is mandatory, the board audits the company's accounts unless the by-laws provide otherwise.

3.3.2 Should the board of auditors become aware or have reason to suspect misbehaviour by directors' or managers' it must act in order to reduce or remove the harmful consequences thereof[38]. It may call a shareholders' meeting and/or file a complaint with the court for serious irregularities. Listed companies' boards of auditors may also call a meeting of the board of directors or the executive committee (such powers can also be exercised by at least two members of the board of auditors) and must report to CONSOB of any irregularity of which they become aware.[39]

3.3.3 The members of the board of auditors must perform their duties with the professionalism and diligence required by the nature of their office. They are jointly and severally liable with directors to the corporation and to its creditors for the directors' acts and omissions, where the damage would not have occurred had they complied with their auditing duties.

3.3.4 Bankruptcy trustees often sue members of the board of auditors for damages according to the provisions described under 3.3.1 to 3.3.3 alleging that:

- they failed to execise their powers so as to avoid or reduce the damage brought to the corporation and its creditors by directors' or managers' acts and omissions:

- the corporation and its creditors would have suffered no damage (or a lower one) if the members of the board of auditors had complied with their duties.

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[36] Article 2489, Civil Code.

[38] Note that board of auditors members are under a duty to take part to board of directors and executive committees meetings (Article 2405, Civil Code) and that they may at any time carry out inspections, also individually, and apply to the directors for information on the company's management (Article 2403-bis, Civil Code).

[39] Articles 149, paragraph 3, and 151, paragraph 2, Legislative Decree No. 58 of February 25, 1998.

3.3.5 Whilst the provision clearly requires that a causal link between the auditors' failure to comply with their duties and the damage to the corporation and/or its creditors be established, courts tend to shift upon defendants the burden of proving that the damage would have been avoided or reduced if auditors had complied with their duties. Further, courts are usually severe in evaluating auditors' conduct when directors kept running the company in violation of their duties under the recapitalize or liquidate rule or under provisions concerning the management of dissolved companies.

3.3.6 Like directors, members of the board of auditors may be held liable to shareholders and third parties according to general tort law principles.

3.3.7 Like directors, members of the board of auditors may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.4 Members of the supervisory board

3.4.1 The supervisory board of companies having opted for the two-tier governance system performs an auditing function which is very similar, in terms of powers and duties, to that pertaining to the board of auditors. There are, however, two relevant differences. First, the company's by-laws may not charge the board with the audit of the company's accounts, a task which always has to be performed by an external auditor. Second, the board appoints and removes management board members and it may also bring a liability suit against such members on behalf of the corporation.

3.4.2 According to the Civil Code, members of the supervisory board must perform their duties with the diligence required by the nature of their office and are severally and jointly liable with the members of the management board for the latter's acts and omissions where the injury would not have occurred if they had complied with their auditing duties.[40]

3.4.3 Liability to shareholders and third parties according to general tort law principles applies to supervisory board members as well.

3.4.4 Like directors, supervisory board members may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.5 External auditors

3.5.1 SpA are required to have external auditors reviewing their accounts, but the by-laws of closely-held SPA may delegate such review to the board of (internal) auditors.

3.5.2 External auditors are required by law to verify:

(a) during the fiscal year, that companies' accounts are kept properly and their transactions reported correctly in the accounting records;

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[40] Article 2409-terdecies, Civil Code.

(b) that companies' annual and consolidated accounts correspond to the results of the accounting records and tests performed and that they comply with the relevant statutory and regulatory provisions.[41]

3.5.3 External auditors may obtain documents and information from the company's directors and may carry out examinations, inspections and controls; with respect to listed companies, they must report to the board of auditors and to CONSOB without delay of any irregularities.[42]

3.5.4 External auditors are jointly and severally liable with directors to the corporation and to its creditors for the directors' acts and omissions, where the damage would not have occurred if they had complied with their duties.[43]

3.5.5 If the external auditor is a legal entity, liability extends to the persons who have audited the company's accounts on its behalf.

3.6 *De facto* directors

3.6.1 Italian courts hold that the directors' liability regime equally applies to anyone, whether a shareholder or an outsider, who acts as a director in a systematic way, even in the absence of any kind of formal or informal appointment.

3.6.2 *De facto* directors may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta* (see above 2.4).

3.7 Sole shareholder

3.7.1 The Civil code provides that, in the event of insolvency, for obligations incurred during the period in which the shares were held by a sole shareholder, such a shareholder will be unlimitedly liable for the company's obligations:[44]

(a) when capital contributions have not been fully paid upon subscription; or

(b) if the directors or the sole shareholders omit to file with the Companies Register a declaration identifying the sole shareholder.

3.7.2 According to case law, which always provided for the unlimited liability of the sole shareholder of an insolvent SpA, shares were deemed to be owned by a single shareholder when he formally held all the outstanding shares or when the other shareholders were mere nominees. So, for instance, courts have consistently held that no sole shareholder existed when most of the shares were held by one company and the remaining shares were held by one of its wholly owned subsidiaries. Some commentators doubt whether such a formalistic interpretation will be confirmed under the new regime, meaning that a company with a "quasi-sole" shareholder who has not fully paid up his shares or who has omitted to declare he is the sole shareholder may be held liable for his company's obligations.

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[41] Article 2409-ter, Civil Code, and Article 155, Legislative Decree No. 58 of February 25, 1998.
[42] Ibidem.
[43] Article 2409-sexies, Civil Code, and Article 164, Legislative Decree No. 58 of February 25, 1998.
[44] Article 2325, Civil Code.

3.7.3 According to the prevailing case law, the sole shareholder cannot himself be declared bankrupt as a consequence of his unlimited liability for a company's debts.

3.8 Shareholders exercising a back-up business (*impresa fiancheggiatrice*)

3.8.1 As previously mentioned, shareholders may be held liable if they are found to have acted as *de facto* directors or in the case of a parent company, abusing its "direction and coordination" powers (see 3.10.3) or, finally, under general tort law principles (see 3.11). If none of these situations occurs, shareholders will not be held liable for the company's obligations.

3.8.2 Italian courts have, however, developed a doctrine under which individuals controlling a group of companies and coordinating and directing such companies' activities may be held to carry-out a back-up commercial business ("*impresa fiancheggiatrice*") and hence may be declared insolvent as such.[45] However, such individuals will only be liable for debts incurred personally and in the exercise of such a back-up business, as opposed to debt incurred by their controlled companies. As a matter of practice, only controlled companies' creditors having obtained a personal guarantee from such shareholders will have a claim against them.

3.8.3 This doctrine also implies that such shareholders may be held criminally liable for the actions described above (see 2.4), even in the absence of a showing that they are *de facto* directors of the insolvent company.

3.9 SRL shareholders deciding or authorizing harmful acts

3.9.1 With regard to SRL only, the 2003 company law reform has innovated in the area of shareholders' liability for management actions. Any shareholder may be held jointly and severally liable with the company's directors for damages resulting from actions taken by the directors in breach of their duties upon the wilful instructions or authorization of such shareholder.[46]

3.10 Groups of companies and the liability of parent companies and their directors

3.10.1 According to one of the most obscure provisions in the 2003 company law reform,[47] under certain circumstances parent companies and their directors may be held liable for the damages caused to the subsidiaries' shareholders or creditors.

3.10.1.1 This new liability regime applies to legal entities[48] with so-called "direction and coordination" powers over a company.[49] The law does not set forth specific criteria for determining when an entity exercises *de facto* "direction and

45 Under Italian law, only companies and individuals exercising a commercial (i.e. non agricultural) business may be declared insolvent.

46 See Article 2476, paragraph 7, Civil Code. As noted by early commentators, although this provision expressly applies only to limited companies, it cannot be excluded that this rule may be extended by the courts to corporations.

47 Article 2497, Civil Code.

48 The terms used by the law ("*le società o gli enti*") are broad enough to encompass any person other than individuals.

49 See Article 2497, Civil Code.

coordination" powers over a given company and, because the law is so new, there have as yet been no judicial interpretations of the specific "direction and coordination" concept. However, based on a similar concept under the Prodi Law and legal scholarship, a court may find that an entity has "direction and coordination" powers with respect to a given company where a significant part of the management decisions at the company (a "Directed Company"), although formally implemented by the Directed Company's managers, is continuously and substantively taken by management at another entity (a "Directing Entity").[50] The new legal framework also applies when an entity exercises direction and coordination powers over a company pursuant to *ad-hoc* agreements or by-laws provisions.[51]

3.10.2 Although control does not in and of itself amount to "direction and coordination" power,[52] a parent entity is rebuttably presumed to exercise "direction and coordination" powers with respect to (i) any subsidiaries for which consolidation is compulsory,[53] and (ii) any subsidiaries under its sole control.[54] To rebut this presumption, convincing evidence of appropriate management independence at the subsidiary company should be provided. If management decisions at the subsidiary company are effectively independent of the parent entity's influence, the new regime would not apply.

3.10.3 Under the new regime, a Directing Entity may be liable to minority shareholders and creditors of a Directed Company for abuse of "direction and coordination" powers.[55] In particular, a Directing Entity that, acting in its own interest or in the interest of third parties, mismanages a Directed Company, is liable:

(i) to the Directed Company's other shareholders for any ensuing damage affecting returns on, or the value of, their shareholdings therein; and

(ii) to the Directed Company's creditors for any impairment caused to the Directed Company's assets that may affect the creditors' ability to collect on their claims.

3.10.4 Any person concurring in the mismanagement (e.g., the Directing Entity's directors), or benefiting from it (e.g., another subsidiary of the Directing Entity), is jointly and severally liable with the Directing Entity.[56]

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50 A single act of interference in management decisions should arguably be irrelevant, as the new regime is intended to apply only when direction and coordination powers are exercised as an "activity."

51 See Article 2497-septies, Civil Code.

52 See Art. 2497-sexies, Civil Code.

53 Whether consolidation is mandatory should be determined by the law of the parent entity. If Italian law applies, the instances of mandatory consolidation are set forth in Articles 25 through 28 of Legislative Decree No. 127 of April 9, 1991, implementing the 7th EC Company Law Directive. Consolidation of a jointly-controlled company is possible but not mandatory (see Article 37).

54 For these purposes, control is defined as (i) holding (directly or indirectly) more than 50% of the vote at a company's ordinary shareholders' meeting, (ii) exercising a dominant influence at the company's ordinary shareholders' meeting through the (direct or indirect) exercise of voting rights, or (iii) exercising a dominant influence on the company through contractual arrangements. See Article 2359, Civil Code.

55 See Article 2497, Civil Code.

56 The liability of persons benefiting from the mismanagement is limited to the benefits actually received by such persons (see Article 2497, paragraph 2, Civil Code).

3.10.5 Liability is excluded when damages resulting from the mismanagement are: (a) fully reversed, including through subsequent transactions specifically effected for this purpose, or (b) offset by the overall effect of the "direction and coordination" activities over the Directed Company.

3.10.6 Creditors or minority shareholders may bring action only if they have been unable to collect damages from the Directed Company. Therefore, liability of a Directing Entity may in practice be limited to those cases in which the Directed Company itself has become insolvent.

3.10.7 Under the Prodi Law, in the case of a group of companies, the directors of the parent company may be held liable for the damages caused to any insolvent subsidiary by means of an abuse of direction powers within the group.

3.11 Other third parties under general tort law principles

3.11.1 Third parties involved with the business of a company which enters into a bankruptcy proceeding may be subject to liability if all or part of the loss suffered by the insolvent company is caused by their wrongful action. The plaintiff must establish the existence of (i) a wilful misconduct or gross negligence by the third party; (ii) the damage caused to the company; and (iii) a casual link between the two.

3.11.2 The loss may either be general - i.e., suffered by the company, and therefore by all the creditors - in which case the bankruptcy trustee must bring the action or the loss may be specific to one creditor, and therefore the action must be brought by the creditor.

3.11.3 The action is a civil action which results in the payment of damages (either to the company, in the event of an action brought by the bankruptcy trustee, or to the single creditor, in the event of an action brought by an individual creditor).

3.12 Banks

3.12.1 Most suits against third parties as in 3.11 above are brought against banks or financial institutions which dealt with the insolvent company. The claim is generally based on an abusive grant of financing or an unjustified interruption of financing.

3.12.2 Banks which financed a company in an insolvency situation, thereby delaying the opening of a formal insolvency procedure in order to gain certain advantages (e.g., in order to avoid claw-back actions, or to obtain specific guarantees), may be held liable against the company's creditors once the company is declared bankrupt. In fact, the creditors would not have started or continued a business relationship with the company if the insolvency situation were apparent and not hidden by the bank's grant of financing. The loss is specific to the injured creditors and the action against the bank is brought by such creditors and not by the bankruptcy trustee.

3.12.3 An unjustified interruption of financing occurs when a bank, without any legitimate reason, stops granting financing to a company, thereby causing its insolvency and the opening of a formal bankruptcy proceeding. In this case, the damage is suffered by the company and therefore the action shall be brought by the bankruptcy trustee.

QUESTION 4

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4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counter-party dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside.

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Transaction potentially subject to an action to set aside

4.1.1 The Bankruptcy Law permits the bankruptcy trustee of a company to bring actions for the revocation of certain payments and transactions carried out during the suspect period (bankruptcy claw-back procedure, or *revocatoria fallimentare*). The goal of such actions is to reconstitute the company's assets in the interest of all creditors by unwinding certain transactions which (i) have been carried out to the detriment of the company, or (ii) are unfairly beneficial to a specific creditor, and thus violate the general principle of equal treatment of creditors (*par condicio creditorum*).

4.1.2 A similar remedy (ordinary claw-back procedure or *revocatoria ordinaria*) is also provided for by the Civil Code: a creditor may challenge transactions or other acts undertaken by its debtor which defraud his rights, irrespective of the fact that such transactions or acts are linked to the suspect period, and subject only to the statute of limitations.

4.1.3 In light of the foregoing, a third party contracting with a company runs the risk that transactions entered into with the company during the suspect period (or even before) may be revoked on the basis of the described actions.

4.2 Summary of heads of challenge

4.2.1 Bankruptcy claw-back procedure (*Revocatoria fallimentare*)

4.2.1.1 Bankruptcy claw-back procedures are meant to void transactions carried out by a company during the suspect period to the detriment of creditors. The relevant suspect period varies based on the specific act or transaction:

(i) certain actions which fall within the ordinary course of business (i.e., transactions for adequate consideration, payments of due and payable debts, and the granting of security interests upon contracting a debt) may be voided if (a) they have been carried out within a one-year period prior to the opening of the bankruptcy proceeding, and (b) the bankruptcy trustee proves that the company's counterparty had actual knowledge of the company's insolvency at the time the transactions occurred;[57]

(ii) certain actions which are outside the ordinary course of business (i.e., transactions for inadequate consideration, discharge of due and payable debts effected through abnormal means of payment, and pledges and mortgages granted for pre-existing debts not yet due and payable) may be voided if they have been carried out within two years prior to the opening of the bankruptcy proceeding; the company's counterparty may avoid the claw-back by proving that it did not have actual knowledge of the company's insolvency at the time the transactions occurred;

(iii) pledges and mortgages granted as security for due and payable debts may be voided if they have been granted within the one-year period prior to the opening of the bankruptcy proceeding; once again, the company's counterparty may avoid the claw-back by proving that it did not have actual knowledge of the debtor's insolvency at the time the security was granted;

(iv) acts without consideration and early payments of debts maturing on the opening day of the formal insolvency proceedings or thereafter are without effect, if they have been made within the two-year period prior to the opening of the bankruptcy proceeding.

The bankruptcy claw-back procedure is also available in the case of *amministrazione straordinaria* (extraordinary administration), but only if the *amministrazione straordinaria* involves a sale of corporate assets or the claw-back procedure is compatible with the restructuring plan.

4.2.2 Clawback (*Revocatoria ordinaria*)

4.2.2.1 Beside the specific claw-back procedure under the Bankruptcy Law, the Civil Code[58] grants creditors a general right to challenge transactions which defraud their rights. This remedy is available regardless of the fact that the company is insolvent. Once the bankruptcy proceeding has been opened, however, only the bankruptcy trustee is entitled to bring this type of action on behalf of all creditors.

4.2.2.2 The requirements for the *revocatoria ordinaria* are: (i) the existence of a damage to the interests of the creditor, and (ii) the knowledge by the debtor and by the third party of the damage caused to the creditor's interests. If the action causing prejudice to the creditor was taken before the date on which the creditor's claim arose, evidence must be provided that such action was

[57] Article 67, paragraph 2, Bankruptcy Law. In the case of a legal entity (such as a corporation), knowledge is determined by reference to the knowledge of the directors or the officers who contracted with the counterparty. Knowledge may be proved by showing, through circumstantial evidence, that a person using normal diligence would have become aware of the insolvency, (e.g., through public notices of default on promissory notes or executive actions).

[58] Article 2901.

planned for purposes of prejudicing the satisfaction of the creditor's receivable, and that the third party wilfully participated in such design. The *revocatoria ordinaria* can be quite a lengthy procedure and the burden of proof for the plaintiff is difficult to meet.

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 In the case of an insolvency proceeding, the action for damages against directors, members of the board of auditors and of the supervisory board, general managers, *de facto* directors, external auditors and liquidators may only be brought by the bankruptcy trustee.[59] The same is true about actions against parent companies and their directors for damages suffered by the subsidiary's creditors.[60]

5.2 Actions against the sole shareholders (3.7) or to shareholders exercising a back-up business (3.8) pertain to individual creditors of the insolvent company or of the business respectively: the trustee may not exercise them collectively. In the latter case, however, the insolvent company might also be a creditor of the back-up business, whereupon the action will pertain to the trustee.

5.3 In the event of bankruptcy of a Directed Company, the action inuring to the creditors as described above (3.10.3) can only be exercised by the bankruptcy liquidator.[61]

5.4 With the exception of the action referred to under 5.3, even during insolvency proceedings, nothing prevents individual creditors and other third parties from suing directors and other persons (see 3) for damages personally and directly received as a consequence of the latter's actions or omissions, when the action is based upon general tort law principles (see 3.11.2).

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59 Article 146, Bankruptcy Law.
60 Article 2497, Civil Code.
61 Ibid., paragraph 4.

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in question 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 For causes of action outlined under 2.1, 2.2, 2.3, 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.9, 3.10, 3.11, and 3.12, liability is civil and extends only to actual damages with a causal link to the defendant’s acts or omission, subject to the qualifications provided above. For causes of action described above under 3.7 and 3.8, the shareholders are personally liable for the company’s or the business debt.

6.2 No disgorgement of profit remedy is available under Italian law.

6.3 As mentioned above, the *revocatoria fallimentare* and the *revocatoria ordinaria* are aimed at obtaining a voidance of the transaction under challenge. As a consequence of such voidance, the goods that have been transferred from the company to third parties or their proceeds must be returned.

6.4 Penalties for criminal bankruptcy and fraudulent bankruptcy have been described under 2.4 above. According to general principles, a person found liable for a criminal offence may also be held liable for civil damages caused to third parties by his conduct; the final decision of a criminal court is binding on a civil court adjudicating a civil liability case if such decision is rendered after a full trial.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company’s affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any obligations (e.g., in the UK and other European jurisdictions Article 6 of the European Convention on Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Obligation to commence insolvency proceedings

When a company faces an insolvency situation, the directors or liquidators have the legal obligation to file a petition for a bankruptcy declaration, or commence another insolvency procedure. If they fail to do so, they may incur a criminal penalty (see 1.2.2 and 2.4).

7.2 Participation in the initial steps of the proceedings

Before the bankruptcy declaration, the bankruptcy court shall carry out a preliminary investigation in order to asses the insolvency situation. As part of such preliminary investigation, the court must summon the company directors.

7.3 Personal duties after the bankruptcy declaration

Once the company has been declared bankrupt, company directors and liquidators are subject to certain obligations. In particular, they cannot leave their place of residence without the authorization of the judge in charge of the bankruptcy proceeding. They may also be deprived of their passport. In addition, they must appear before the judge in charge of the bankruptcy proceeding, bankruptcy trustee or creditors' committee whenever they are requested to do so. If they fail to appear as requested, the judge in charge of the bankruptcy proceeding may require the police to force them to appear.[62]

7.4 Obligation to cooperate during the bankruptcy proceeding

7.4.1 Given that the directors of a bankrupt company are often best placed to know and understand the company and its activities, their collaboration with the bankruptcy court and with the officers appointed to conduct the bankruptcy proceedings is invaluable. Italian Law thus provides for the close involvement of the company's directors in the proceedings.

7.4.1.1 Beside the general duties described under 7.3 above, the directors have certain specific obligations such as the following.

7.4.2 Immediately after the bankruptcy declaration, the bankruptcy trustee shall draw up a report of the assets of the company, and before completing the report he shall ask the directors whether they are aware of any assets which have not already been included in the report. The directors must provide a response, and if they fail to do so, they may incur in criminal liability.[63]

7.4.3 The directors must be heard by the judge delegated to oversee the drawing up of the lists of creditors' claims, and attend the meeting scheduled for the verification of such claims, although such attendance is not mandatory nor sanctioned in any manner.

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62 Articles 146 and 49, Bankruptcy Law.

63 Article 87 and 220, Bankruptcy Law.

7.5 Human rights

7.5.1 Italy is a contracting party to the European Convention for the protection of Human Rights and Fundamental Freedoms (Treaty of Rome dated November 4, 1950, the "Convention"), the provisions of which have been incorporated into Law No. 848 of August 4, 1955.

7.5.2 The persons identified in response to question 3 will thus be entitled to rely upon the rights contained in the Convention (the "Convention Rights"). This is the case whether such persons are individuals or companies. In a bankruptcy context, a legal representative, director or other person entitled to Convention Rights under the Convention will be able to:

(i) require that a particular provision of insolvency law is construed in accordance with such Convention Rights or otherwise declared incompatible; or

(ii) claim that judicial bodies are a public authority and are acting unlawfully in breach of that person's Convention Rights.

7.5.3 In the context of bankruptcy proceedings, and the duty of cooperation discussed above, certain Convention rights may be particularly relevant. These include:

(i) Article 6 - the right to a fair trial;

(ii) Article 4 - prohibition of slavery and forced labour;

(iii) Article 8 - right to respect for private and family life;

(iv) Protocol 1, Article 1 - right to peaceful enjoyment of possessions.

7.5.4 Case law on the application of the Convention to bankruptcy proceedings is, however, particularly scarce in Italy.

QUESTION 8

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8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower court.

8.1 Statute of limitations

8.1.1 The statute of limitations for:

(i) actions for damages against directors, board of auditors members, supervisory board members, general managers, voluntary liquidators, external auditors, and *de facto* directors, when based upon violations of their duties to the corporation, is five years *from the date when the relevant person has ceased from office*;[64]

(ii) actions for damages against directors, general managers, board of auditors members, voluntary liquidators, external auditors and *de facto* directors, when based upon violations of their duties to creditors (2.2.5), is five years from the date when the damage has occurred,[65] i.e., according to the case law, *from the date when the company's assets have become insufficient for the payment of the company's debts* (this can be a date prior or subsequent to that in which the court declares the company insolvent, although courts tend to presume that the two dates coincide). According to some court decisions, if the defendant has ceased from office after the company's assets have become insufficient, the five-year period starts from the termination date;

(iii) actions for damages against SRL directors and shareholders (2.2 and 3.9), is five years from the date when the damage has occurred.[66] However, if, as is usually the case, the damage occurs before directors leave office, the five-year period starts from the termination date;

(iv) all of the actions for damages described above under 2 or 3 which are based upon tort law principles, is five years from the date of the harmful act or omission.[67]

8.1.2 Sole shareholders are liable for the debts of their company in special circumstances (3.7). Similarly, shareholders exercising a back-up business are liable for the debts incurred in such activity. Actions against them can be brought so long as the relevant claims, whether stemming from a contract or from torts, are not statute barred. Subject to specific exceptions, the statute of limitations for actions relating to claims arising from a contract is ten years, while it is five years, as mentioned, for torts claims.

8.1.3 The majority of commentators holds that the liability of Directing Entities (3.10) is a specification of general tort law principles. If this is so, then the statute of limitations for such actions for damage is also five years. Otherwise, if liability is deemed to be contractual in nature, the statute of limitations is ten years.

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64 Articles 2393, 2396, 2407, 2489, Civil Code; Article 223-septies, *Disposizioni di Attuazione del Codice Civile*; Article 164, Legislative Decree No. 58 of February 25, 1998.

65 See Article 2949, Civil Code; Article 223-*septies, Disposizioni di Attuazione del Codice Civile*; Article 164, Legislative Decree No. 58 of February 25, 1998.

66 See Article 2949, Civil Code.

67 Article 2947, Civil Code.

8.1.4 The statute of limitations for the *revocatoria ordinaria* is five years from the date when the transaction being challenged is carried out, whereas the statute of limitations for the *revocatoria fallimentare* is five years from the date of the bankruptcy declaration.

8.1.5 According to the general rules of Italian criminal law, the statute of limitations for criminal offences depends on the applicable sanctions. Accordingly, the statute of limitations for *bancarotta semplice* and for *bancarotta fraudolenta*, under normal circumstances, is 5 and 15 years, respectively.

8.2 Appeals

8.2.1 Any decisions rendered by lower courts are subject to appeals, and the decisions of the courts of appeal are subject to revision by the Supreme Court, but only on the basis of violations of laws.

QUESTION 9

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9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 In general, Italian company law applies to companies incorporated in Italy and to companies incorporated abroad having their administrative seat or their principal place of business in Italy.[68] Therefore, liability actions described above and based upon company law provisions[69] may be brought against such entities' directors and other relevant persons.

9.1.1 As a general matter, it is doubtful whether, in the light of the *Centros* case law,[70] the conflict of law rule described under 9.1 would withstand scrutiny from the European Court of Justice with respect to companies incorporated in other EU jurisdictions.

9.2 Italian tort law applies if the harmful event (as opposed to the harmful act or omission) has occurred in Italy.[71]

9.3 It is widely debated whether provisions on Directing Entities liability apply to foreign directing entities as well. As previously highlighted, it is also uncertain whether such Entities' liability for undue influence upon their subsidiaries is an application of general tort law principles. Arguably, if it is indeed an

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68 Article 25, Law No. 218 of May 31, 1995.

69 See above, 2.2, 2.3, 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.7., and 3.9.

70 See Cases C-212/97, Centros Ltd. v. Ehtvers-og Selskabbsstyrelsen, 1999 E.C.R. I-1459; C-208/00, Überseering v. Nordic Construction Company Baumanagement GmbH (NCC), 2002 E.C.R. I-9919; C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd., ECR I-(30.9.2003).

71 Article 62, Law No. 218 of 31 May, 1995.

application of such principles, then the rule described under 9.2 should apply. If it is, instead, part of company law, then the rule described under 9.1 should apply.

9.4 With regard to liability of shareholders exercising a back-up business, the citizenship or nationality of the shareholders is irrelevant, provided that, according to conflict of bankruptcy law rules, their business may be declared insolvent by an Italian court (see 9.5 below).

9.5 Pursuant to Article 9 of the Bankruptcy Law, the bankruptcy procedure applies not only to companies having their principal place of business in Italy, but also to companies having their principal place of business abroad but operating in Italy. The commencement of bankruptcy proceedings abroad will not prevent the commencement of bankruptcy proceedings against the same company in Italy.

9.6 Once jurisdiction has been accepted by an Italian court, all judicial remedies provided by Italian law will be available.

9.7 At the European Union level, Council Regulation No. 1346/2000 sets forth the rules governing cross-border insolvency proceedings "*which entail the partial or total divestment of a debtor and the appointment of a liquidator*". Pursuant to Article 3 of such Regulation, the courts of a Member State within the territory of which the centre of a debtor's main interests is situated shall have jurisdiction to open insolvency proceedings, whereas the courts of another Member State shall have jurisdiction to open insolvency proceedings against the debtor only if it possesses an establishment within the territory of that other Member State, and the effects of those proceedings (the so-called "*secondary proceedings*") shall be restricted to the assets of the debtor situated in the territory of the latter Member State.

9.8 The law applicable to insolvency proceedings and their effects (i.e., the conditions of their opening, their conduct and their closure) shall be that of the Member State within the territory of which such proceedings are opened[72]. The Regulation also contains specific provisions for creditors' claims.

9.9 The law of the State of the opening of proceedings also determines the rules relating to the voidability or unenforceability of legal acts detrimental to all creditors. However, such rule does not apply where the person who benefited from an act detrimental to all the creditors proves that (i) the said act is subject to the law of a Member State other than that of the State of the opening of proceedings, and (ii) such law does not allow any means of challenging that act in the relevant case.

[72] Article 4, Regulation No. 1346/2000

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above.

10.1 Directors' and officers' insurance policies covering the exposure of directors of Italian corporations are available in the Italian insurance market. First introduced in the US and UK in the late fifties and in civil law countries in the late seventies, these types of insurance started to materialize in Italy in the early nineties. In most of the cases, insurance policies are not executed by the directors, but rather are entered into by the company on behalf of its directors.

10.2 In practice, while insurance companies are generally willing to cover the liability of directors vis-à-vis the company's creditors and shareholders as well as third parties directly damaged, they are not always available to cover the directors' liability vis-à-vis the company. Insurance policies typically cover the directors' civil liability resulting from faults, errors, omissions, mistakes and erroneous interpretations of legal or regulatory provisions. Insurance policies will always exclude any form of fraudulent behaviour, whereas coverage for acts which are the consequence of gross negligence can be negotiated.

10.3 In light of the company law reform which came into force on January 1, 2004, it is debated which is the competent corporate body of the company that shall resolve on the execution of insurance policies for and on behalf of company directors. According to the majority of Italian scholars such insurance policies constitute a form of compensation and, therefore, they must be approved by the shareholders, unless they refer to directors vested with special powers in compliance with the by-laws, in which case the relevant resolution is entrusted with the company's board of directors.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.2 Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period?

11.1 Italian law does not preclude directors or other officers from incurring further credit during the twilight period, but rather sanctions their conduct when the specific circumstances of the case show that the reasons for a particular transaction are not in the interest of the company or may otherwise be considered as an act of mismanagement. Accordingly, one shall not conclude that incurring further credit during the twilight period is *per se* likely to be sanctioned by Italian courts.

11.1.1 However, a strict scrutiny will normally be adopted in considering transactions entered into when a company faces financial difficulties. Therefore, directors and other officers shall take an extremely prudent approach when considering the opportunity to incur further debt in the twilight period.

11.2 As noted in paragraph 4 above, the Bankruptcy Law subjects to claw-back procedures a variety of actions undertaken during the twilight period. Some of them, however, will not be affected unless the third party dealing with the company is aware of the insolvency situation, or of the prejudice that the specific transaction is causing to the company's creditors.

11.2.1 A third party dealing with a company that is facing an insolvency situation must take a different approach depending on whether such party is aware of such situation. In the affirmative, certain types of transactions shall not be entered into under any circumstances, and other types of transaction shall be prudently evaluated, whereas in the negative case, an ordinarily cautious approach will prevent the transaction from being challenged in the future.

JAPAN

QUESTION 1

1. The start and duration of the “twilight” period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by acompany are vunerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

1.1.1 In general, Japan's Bankruptcy Law has no clear period that can be labelled as the "twilight zone" as sometimes found in other systems. The bankruptcy law is scheduled for major revisions, which will be effective from January 1, 2005 and the expected changes are noted in italics. Minimal substantive effects are foreseen, with the exception of items noted. In general, the changes noted here are intended to bring uniformity between the Bankruptcy Law and the related Civil Rehabilitation Law and Corporate Reorganization Law.

In a standard bankruptcy filing, there is no automatic stay between the time of filing and the adjudication of bankruptcy. However, there is a right of avoidance, which may affect certain transactions that occur prior to the start of bankruptcy proceedings. Directors and officers may be subject to higher risk of criminal and civil liabilities resulting from transactions that occur during this period, with increased scrutiny falling on transactions that are voided. The bankruptcy law provides several types of transactions, and restrictions thereto, with respect to the period preceding adjudication of bankruptcy, which the bankruptcy trustee may void by exercising the right of avoidance. The transactions which may be set aside include:

(a) Any transaction where the obligor and the beneficiary of the transaction know that such transaction would prejudice creditors (Bankruptcy Law, Art 72, Para 1 *[to be amended to Art 160 Sec 1, Para 1, effective January 1, 2005]*).

(b) Any provision of security (collateral) or extinguishment of obligation, or similar transaction, by the obligor that is prejudicial to creditors, that occurs after the obligor's suspension of payment, or the filing of the bankruptcy petition, provided that the beneficiary of such transaction knew of the prejudicial effect, where the burden of proof regarding such knowledge rests with the bankruptcy trustee *(Bankruptcy Law, Art 72, Para 2 [Art 160, Sec 1, Para 2, Art 162, Sec 1, Para 1]).*

(c) Any transaction under (b) above where the beneficiary is a relative of, or shares a livelihood with, the obligor, provided that the beneficiary of such transaction knew of the prejudicial effect, where the burden of proof regarding lack of knowledge rests with the beneficiary (Bankruptcy Law, Art 72, Para 3 *[to be deleted]*).

(d) Any provision of security or extinguishment of obligation that occurs after the obligor's suspension of payment, or filing of the bankruptcy petition, or within the 30-day period prior thereof, that the obligor has no duty to honour, provided that the beneficiary of such transaction knew of the prejudicial effect, where the burden of proof regarding lack of knowledge rests with the beneficiary (Bankruptcy Law, Art 72, Para 4 *[Art 162, Sec 1, Para 2]*).

(e) Any transaction that is deemed a gratuitous act of an obligor that occurs after the obligor's suspension of payment, or filing of the bankruptcy petition, or within the 6-month period prior thereof (Bankruptcy Law, Art 72, Para 5 *[Art 160, Sec 3]*).

(f) Where under (b), (c), or (d), above, the beneficiary of the obligor's acts knew of the obligor's suspension of payment, but one or more years have lapsed between the subject transaction and the adjudication of bankruptcy, the beneficiary's knowledge may not be relied on as the basis for voiding the transaction (Bankruptcy Law, Art 84 *[Art 166]*).

In the application of the Right of Avoidance, the requirements of the relevant period thereof are usually left to interpretation due to the absence of statutory provisions, with the exception of those described above. In practice, the avoidance of transactions is more likely to be upheld by the court if the underlying transaction occurred within the 3-month period immediately preceding the suspension of payment or filing of the bankruptcy petition. Transactions between 3-months and a year must be increasingly egregious for the trustee to avoid the transaction. Although the statutory language creating the one-year limit described in (f), above, is specific to certain situations, transactions beyond one year are rarely, if ever, voided in practice.

In the context of the application of the right of avoidance referred to above, the risk of personal civil and/or criminal liability of a director or other persons involved in management is increased because of several statutory provisions. Part IV of the Bankruptcy Law consists of penal provisions to be applied specifically for crimes related to bankruptcy, including the actions of directors and managers (Bankruptcy Law, Art 376 *[to be amended and deleted, and replaced by inclusive language in the respective statutes]*). The Bankruptcy Law does not currently provide for civil liability although this will change under the amended Bankruptcy Law *(Amended Bankruptcy Law, Art 177-181)* which provides for the trustee to bring an expedited action to determine the civil liability of a corporate director and certain other officers for direct damages. Courts may also bring such an action on their own accord. In conjunction with the commencement of such action, the trustee may ask for, or the court may apply, a provisional attachment on the defendant director's (officer's) assets. Although the amended statutes are silent as to whether these new provisions preclude pursuit of civil liability action under other laws such as the Commercial Code, there are scholarly opinions that favour such preclusion. By this definition, the preclusion is limited to those who have standing, namely the trustee, while those unnamed in the new provisions, such as creditors, continue to have avenues of relief through such other laws.

No penal provision of the Bankruptcy Law exclusively applies to the period covered by the Right of Avoidance although in practice, potential fraudulent activity by the management of the debtor company is most likely to occur during this period. Of the penal provisions, the following are the most relevant to this discussion:

(a) The crime of Fraudulent Bankruptcy includes the concealment or destruction of properties related to the estate in bankruptcy, the disposition of such properties in a manner prejudicial to creditors, and the fraudulent increase of liabilities of the estate, and is punishable with imprisonment not to exceed ten years (Bankruptcy Law Art 374, Paras 1 & 2 [Art 265, *Sec 1, Paras 1 & 2 with the additional punishment of either imprisonment and/or a fine not to exceed ten million yen]*).

(b) The crime of Negligent Bankruptcy includes any provision of security or extinguishment of obligation that is preferential to some creditors notwithstanding existing knowledge regarding the causes of bankruptcy, or that the debtor has no duty to entertain such provision of security or extinguishment of obligation, and is punishable with imprisonment not to exceed five years or a fine not to exceed 300,000 yen (Bankruptcy Law, Art 375, Para 3 *[Art 266 with the potential fine increased to not exceed five million yen, and the possibility of receiving both imprisonment and the monetary fine]*).

Besides the Bankruptcy Law, the Commercial Code provides for both criminal and civil liabilities that are relevant to this discussion.

(a) Under the crime of Special Misappropriation, any director, officer, or employee of a company that, in breach of their duties, acts in order to benefit themselves or third persons, or to inflict damage on the company, and actually causes proprietary damage to the company, is liable to be punished with imprisonment not to exceed ten years or to be fined an amount not to exceed ten million yen (Commercial Code Art 486 Sec 1). Any attempt to commit this crime is also subject to punishment (Commercial Code Art 488).

(b) Directors are jointly and severally liable to the company for the amount of damages caused by an act in violation of law or the articles of incorporation (Commercial Code Art 266, Sec 1, Para 5). This liability may be limited for acts taken in good faith and in the absence of gross negligence (Commercial Code Art 266, Sec 7, 12).

(c) Directors are jointly and severally liable to third persons for damages caused by acts involving wrongful intent or gross negligence (Commercial Code Art 266-3, Sec 1).

In practice, criminal charges based on the penal provisions of the Bankruptcy Law are rarely pursued; charges are more often brought under the Commercial Code and other laws. With respect to civil liability, the lack of any such provisions under the Bankruptcy Law requires aggrieved parties to seek remedies under the Commercial Code and other laws.

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the “twilight” period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above: -

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

2.1 Major acts by the company for which directors may be held personally liable are trading acts, the transfer of property, the performance of an obligation, and the provision of security. In practice, because the transfer of property through a transaction is customary for a company, it is rare that such a transfer would cause a director to incur liability, except in cases such as the transfer of property without compensation, or at an extremely low price with an intention to benefit specific creditors. However, new obligations assumed despite a clear state of insolvency, may be deemed a fraudulent act done to benefit the other party to the transaction. Directors' conduct is subject to scrutiny with respect to the performance of existing obligations and the provision of security, in transactions where the Right of Avoidance may be exercised.

2.2 A director may incur both civil and criminal liabilities. However, in practice, the imposition of criminal liability is rare. In addition, because civil liability is not provided under the current Bankruptcy Law, there is no effective mechanism exclusive to the bankruptcy process, and civil liability must be pursued under the Commercial Code and other laws. Apart from civil liability under law, in Japan, representative directors of small- and medium-sized companies usually personally guarantee certain of companies' debts, where the directors are contractually liable as co-signers of each loan. Therefore, in practice, upon a company's bankruptcy, the representative director often becomes personally insolvent making any additional civil liabilities moot. In larger companies, where the management lies with a broader board of directors, the personal guarantee of the representative or any other director is less common, and the discussion is relevant. In such cases, the pursuit of civil liability against directors becomes practical.

2.3 The civil liability incurred by a director to compensate for damage is based on the provisions of the Commercial Code. A director is liable for all the actual damage incurred by a company. In addition, a director is liable for actual damage to a third party for damages suffered by the creditor concerned. Provisions under the Commercial Code allow claims against a director to the extent that there is reasonable cause and effect between the damage and the director's act that violates laws and ordinances or the articles of incorporation, or his or her gross negligence.

2.4 A director attends meetings of the board of directors and signs board minutes of the board's resolutions, and so, all directors who do not raise objections and have them noted are jointly and severally liable for the consequences of those resolutions. However, in practice, there is the possibility that the extent of a director's involvement will be considered in determining the actual share of responsibility.

2.5 As stated above, the Bankruptcy Law does not provide for civil liability claims and such claims must be brought under the Commercial Code and other laws. While the "twilight zone" period in terms of increased risk of avoidance and personal liability is unclear, the statute of limitations under Japan's Civil Code for claims under the Commercial Code, including those for the personal liability of directors, is construed as ten years by court precedent. However, for "twilight zone"-related liability, the increased risk to directors corresponds to the period during which transactions may be voided, immediately preceding the suspension of payment, or filing of bankruptcy, as described in the answer to Question 1, above.

2.6 Of all the acts mentioned above, with respect to those acts relating to the right of avoidance, it is an effective defence to prove that the transfer of property, the performance of an obligation, or the provision of collateral, conducted before the filing of bankruptcy, had a proper objective and were executed in good faith. A company can conduct ordinary business activities until the company decides to stop business activities. Therefore, if the act concerned is conducted as a transaction within the scope of ordinary business activities, no criminal liability for that act will be incurred.

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight"period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 The liability to compensate for damage under the Commercial Code is a liability imposed only on directors and statutory auditors. However, there is judicial precedent that affirms the existence of a third party liability, based on Article 266-3, Commercial Code in the case of a substantial entrepreneur who, although not a director at the time of an act, had the right to decide on important matters externally and internally. In addition to directors and statutory auditors, in respect of criminal liability, certain managers (those registered as having the executive power to represent the business) may be charged with the crime of Special Misappropriation. Basically, no persons other than directors are supposed to assume criminal liabilities under the Bankruptcy Law. Under the Commercial Code provisions described in the answer to Question 1, above, persons that may be subject to criminal liability include a broader spectrum and may include employees without executive powers if they have been assigned certain duties and act in violation of those duties. Civil liability to third parties for "twilight zone" related claims are limited to directors and statutory auditors, and in those companies that have adopted the committee form of management, to the executive officers.

3.2 There is no difference in the acts for which parties other than directors may be held liable.

3.3 The measurement of liability is as stated in 2 (b) (ii) above.

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 In terms of the "twilight zone" period, the factor given the most weight in terms of whether a transaction can be voided is whether one or both parties of the transaction knew the company's state of insolvency. In addition, apart from transaction subject to being voided as discussed in the answer to Question 1, above, the bankruptcy trustee must review all existing executory contracts to which the company is a party, and has the option of voiding remaining portions of the contract (Bankruptcy Law, Art 59 *[Art 53]*).

4.2 Defences against challenges of transactions that take place during the "twilight zone" are limited and are based primarily on the counter-party's knowledge of the company's state of insolvency. Where prior knowledge is clear, there is little defence against avoidance.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 For criminal violations under the Bankruptcy Law or the Commercial Code the national government, through the regional prosecutor's office has sole standing to take legal action against directors and others included in Question 3 above.

With respect to a director's civil liability to the company based on Article 266 of the Commercial Code, the bankruptcy trustee has standing to bring suit as part of the bankruptcy process. Prior to the adjudication of bankruptcy, this power rests with the statutory auditor of the company. In legal theory, if the bankruptcy trustee (or the statutory auditor) takes no legal action, shareholders may bring a derivative suit. With respect to third party liability based on Article 266-3 of the Commercial Code, the creditor that suffered the damage has standing to sue. However, where all creditors similarly suffered loss, it is possible that a lead creditor in cooperation with the bankruptcy trustee would bring a combined lawsuit. This problem is left open to some interpretation in the absence of a clear statutory provision.

QUESTION 6

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6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 There are no specific remedies other than the awarding of damages resulting from a civil suit, as described in answers to Questions 1 through 4, above.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 For the purpose of bankruptcy proceedings, the person in bankruptcy, including its directors, is obliged to provide necessary explanations regarding the bankruptcy upon the demand of the bankruptcy trustee, bankruptcy inspector *(to be abolished with the amended Bankruptcy Law, effective January 1, 2005)*, or the meeting of creditors (Bankruptcy Law, Art 153 [Art 40]). Failure to abide by this requirement is a criminal violation, which is punishable by imprisonment not to exceed one year or a fine of no more than fifty thousand yen (Bankruptcy Law, Art 382 *[Art 268, Sec 1 with the punishment becoming imprisonment not to exceed three years, or a fine not to exceed three million yen, or both]*). This duty obliges directors to provide all the information necessary to preserve the assets of the company and to enable the bankruptcy trustee to otherwise perform its duty. In addition, where a representative director is personally insolvent and has filed for bankruptcy, his/her lack of cooperation in explaining the company's bankruptcy may be deemed as a reason to withhold discharge from debts in his/her personal bankruptcy proceedings (Bankruptcy Law, Art 366-9, Para 5 *[Art 252, Sec 1, Para 11]*).

7.2 No such provisions exist.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 In general, the statute of limitations under the Civil Code for civil claims by a creditor is construed as ten years. While no statutory provision exists under the Commercial Code, the courts in Japan have generally construed that civil liability under the Commercial Code should follow similar liability under the Civil Code. The statute of limitation for criminal liability varies depending on the particular law. For the crime of Special Misappropriation under the Commercial Code, the statute of limitation is seven years from the illegal activity. Under the Bankruptcy Law, the statute of limitation is seven years from the illegal activity for the crime of Fraudulent Bankruptcy, whereas the statute of limitation is five years from the illegal activity for the crime of Negligent Bankruptcy. However, in practice, enforcement of the two criminal provisions under the Bankruptcy Law has been rare. Furthermore, although the statute of limitation is seven and five years, respectively, in practice, the enforcement of these laws would require the strong participation of the bankruptcy trustee, whose tenure typically lasts from one to four years. If a criminal investigation by the district prosecutor's office based on these two laws is not commenced during the bankruptcy trustee's tenure, the risk of indictment after the bankruptcy trustee's tenure may be assumed to be lower.

8.2 Appeals against final judicial decisions are available for all statutes regarding criminal and civil liabilities that are described herein. All judicial procedures described above are conducted within the jurisdiction of the District Court. Therefore, all appeals must follow the respective general appeals procedures for criminal and civil decisions. No special appeals process exists for bankruptcy related crimes and civil suits.

QUESTION 9

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9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Under the Bankruptcy Law, foreign persons and corporations have the same status for bankruptcy purposes as Japanese nationals and Japanese corporations (Bankruptcy Law, Art 2 *[Art 3]*).

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 Insurance is not covered under the provisions of the Bankruptcy Law. However, an insurance contract, including D&O insurance, is enforceable under Japanese law. The history of D&O insurance coverage in Japan is still short; purchase of D&O coverage became commonly available in Japan only after 1993, when the Commercial Code was amended, allowing shareholders to bring suit more easily. Publicly known examples of claims under such insurance are still rare. While coverage may vary between insurers, coverage for bankruptcy related liability, if included in D&O policies, has yet to be thoroughly tested in the courts.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 Under Japan's bankruptcy process, a bankruptcy trustee is appointed at the time of adjudication of bankruptcy. Until the appointment of the trustee, all authority and responsibility for executing the business of the company rests with the board of directors and designated officers of the company. Therefore, it is necessary to consider fiduciary duty to the company: apart from whether taking on additional credit increases risk, whether taking the proposed credit can be deemed necessary to the company is also pertinent. If the proposed additional credit is determined to be necessary under the normal course of business, then the board of directors and/or executive officers have a duty to incur such credit. Although this is the theory, in practice, there would be judicial scrutiny of the facts surrounding the transaction and therefore the outcome would differ case-by-case.

In Japan, the chief executive officer of most small- and medium-sized businesses is also the owner and representative director of the company. As such, he/she will already personally guarantee much of the company's debt. In the "twilight zone" period, incurring additional credit would be viewed as natural, if such representative director were acting in the best interests of the company. Therefore, so long as the transaction does not violate the tests of the specific criminal and civil liability statutes described herein, it is very unlikely that the director would incur any additional liability, other than any contractual liability, from his/her decision that the company should incur the additional credit. This notwithstanding, a potential good faith creditor would be expected to determine the creditworthiness of the potential debtor including the state of solvency of the company. Thus, while incurring additional credit by itself is not necessarily egregious, clearing the hurdle regarding prior knowledge without the transaction becoming subject to being voided may be difficult.

NETHERLANDS

QUESTION 1

The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1. Introduction

Absence of any formal twilight period
In the Netherlands, there is no formal twilight period, being a period prior to bankruptcy during which the acts of a company may be questioned or undone. However, the acts of a company in the period immediately prior to the bankruptcy are normally closely scrutinised by the receiver in bankruptcy (*"curator"*) and the creditors.

The receiver in bankruptcy will be particularly interested in mismanagement: if it can be established that mismanagement was an important cause of the bankruptcy, the members of the management board and the supervisory board of the company may be personally liable for the entire deficit in the bankruptcy[1]. The receiver in bankruptcy will also look for transactions that are advantageous to some creditors and at the same time harmful to others. Such transactions may be declared null and void[2].

Creditors will look for evidence that the management board knew that the bankruptcy could not be avoided when the company entered into transactions with those creditors. If they can prove that the management board had reasons to believe that the company might not be able to meet the obligations entered into, (members of) the management board may be personally liable towards those creditors.

The fiscal and social security authorities will normally investigate when exactly the situation arose that the company was not able to meet its obligations to pay certain taxes and social security premiums. If the management board has failed to timely report such inability to the fiscal and social security authorities, this may also lead to personal liability of the managing directors.

The shareholders of the company may query the acts of the company and its management board in the period prior to the bankruptcy, and – if they find the management has not done a proper job – seek to hold (members of) the management board personally liable, although until today the courts in the Netherlands have been reluctant to accept such personal liability.[3]

[1] articles 2:138, 2:149, 2:248 and 2:259 of the Dutch Civil Code ("DCC")
[2] article 42 and following of the Dutch Bankruptcy Act ("DBA")
[3] Courts in foreign jurisdictions - like in the United States of America - seem to have less hesitations, even if it concerns disputes between Dutch companies and its (foreign) shareholders.

The Dutch Bankruptcy Act of 1896

The Dutch Bankruptcy Act of 1896 (**DBA**) is presently under review. Although in the past, partial changes have been made to the DBA, there is no doubt that the present review is going to lead to fundamental changes[4]. The DBA contains three types of insolvency proceedings: bankruptcy (*"faillissement"*), suspension of payments (*"surseance van betaling"*) and debt restructuring for natural persons (*"schuldsanering natuurlijke personen"*). Bankruptcy is a procedure applicable to both natural persons and legal entities, such as companies. As in many other civil law jurisdictions, the court involvement in formal insolvency proceedings is rather strong. In this chapter, only the bankruptcy of companies will be discussed.

NVs and BVs

The two types of companies generally used in the Netherlands are the limited liability company (*"naamloze vennootschap"*; "**NV**") and the private limited liability company (*"besloten vennootschap"*; "**BV**"). Both are legal entities with capital divided in shares, minimal capital requirements and a principle liability of shareholders limited to the amount payable to the company on the shares held. The management board (*"bestuur"*), consisting of one or more managing directors (*"directeuren"*), manages the NV or BV. Sometimes, the management board is supervised by a supervisory board (*"raad van commissarissen"*). Generally, only the management board (or one or more managing directors) can represent and bind the company; the supervisory board cannot. The supervisory board supervises the management of the company and is sometimes required by law or the articles of association of the company to approve documents such as the annual accounts or to approve certain proposed resolutions of the management board. The management and supervisory board have a duty of care vis-à-vis the company itself and the parties related to that company, including its employees, creditors and shareholders. Neither the shareholders nor the managing directors normally assume direct liability to the creditors of the company.

No statutory obligation to apply for an insolvency

Dutch insolvency law does not provide for an obligation to apply for a suspension of payments or a bankruptcy on the basis of a cash-flow or a balance-sheet test. Companies are in principle allowed to continue trading even with negative equity. However, the management board of an NV is obliged to convene a general meeting of shareholders as soon as the management board may reasonably assume that the net asset value of the company is less than 50% of the paid up capital[5].

Specified periods for specific liabilities

Although no formal twilight period exists under Dutch law, there are some relevant time periods for certain specific actions:

(a) Payments of claims that were due and payable may, provided there is no "conspiracy" between the debtor and the creditor, be declared null and void by the receiver in bankruptcy only if the creditor knew that a petition for bankruptcy had been filed[6]. The average period between the filing by a

[4] A first draft of the revised Act is expected in 2005.

[5] article 2:108a DCC

[6] article 47 DBA

creditor and adjudication of bankruptcy by the court is between two and four weeks. An application by the debtor-company for its own bankruptcy may lead to a bankruptcy order being made within one day.[7]

(b) Claims of the receiver in bankruptcy against the management board for the total deficit of the bankrupt estate, based on mismanagement being an important cause of the bankruptcy, can only be based on facts and circumstances that took place within three years before the bankruptcy[8]. A three-year period also applies to claims of the fiscal and social security authorities based on mismanagement[9]. This period is not linked to the date the bankruptcy was adjudicated but to the date on which the company filed (or should have filed) its inability to pay taxes to the authorities.

(c) If the receiver in bankruptcy invokes the Actio Pauliana in respect of a transaction the debtor entered into within one year before the bankruptcy, the DBA provides for a shift of the burden of proof in certain types of transactions. These include transactions with insiders, transactions whereby the value of the transaction on the debtor's side substantially exceeds the value on the creditor's side, and transactions whereby the debtor provides security for a debt not yet due and payable[10].

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:

i. is any resulting liability against a director civil, criminal or both?;

ii. can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

iii. will liability attach to individual directors in proportion to their specific involvement?;

iv. is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

7 Reference is made to the EC directive 2002/47/EG regarding financial collateral arrangements and the draft act for its implementation in Dutch law, currently being discussed in parliament. Although the most recent draft act does not effect article 47 DBA directly, it cannot be excluded that the EC directive 2002/47/EG effects article 47 DBA.

8 articles 2:138 and 2:248 DCC

9 article16 of the Dutch Social Security Co-ordination Act ("DSS"); article 36 of the Dutch Tax Collection Act ("DTCA")

10 article 43 DBA

v. what defences, if any, will be available in relation to each offence?

2.1 General

Directors' liability arises both on the basis of general concepts of law (tort, negligence, breach of duty of care) and some specific articles in the DCC and DBA.

Directors' liability to the company (which in a bankruptcy means the receiver) has a broad basis in article 2:9 DCC: the duties of care of the director to the company (see 6.1. below).

Directors' liability to the receiver in bankruptcy for the deficit of the bankrupt estate can be based on mismanagement which was an important cause of the bankruptcy[11]. The receiver in bankruptcy may also start actions against a director based on tort.

Directors' liability to specific creditors or other third parties shall principally be based on tort (see 6.1 below), such as the "Beklamel"-type of action or misrepresentation of annual accounts.

2.2 Falsification of the company's books

A director who falsifies the books will most likely be liable to the company for failing to perform his duty as a director of the company properly[12]. The normal provisions for limitation of the DCC apply (i.e. 5 years after the falsification has been discovered). The falsifying director also faces criminal liability, although prosecution is rare.

If the books are falsified and the company is subsequently declared bankrupt, it is assumed that the bankruptcy is caused by mismanagement and the director is liable to the receiver in bankruptcy for the entire deficit in the bankruptcy[13]. Similar liabilities exist to the tax and social security authorities for certain tax and social security debts[14]. These liabilities are joint and several liabilities whereas other liabilities are, in principle, individual liabilities. For this type of liability, the acts should have been undertaken in the 3-year period prior to the bankruptcy.

Vis-à-vis the company, the director could argue that the company has not suffered any damages, but hardly any defence is possible vis-à-vis the receiver in bankruptcy and the tax and social security authorities in case of falsification of the books.

2.3 Transactions in fraud of creditors

Transactions in fraud of creditors may give rise to both civil and criminal liability. A director may be personally liable for losses caused by transactions prejudicial to the creditors ("Actio pauliana"). Mitigation of the damage

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[11] articles 2:138, 2:149, 2:248 or 2:259 DCC
[12] article 2:9 DCC
[13] articles 2:138, 2:149, 2:248 or 2:259 DCC
[14] articles 36 DTCA and 16 DSS

awarded by the court is possible.

Individual directors who were involved in the transaction are jointly and severally liable, irrespective of their degree of involvement. Directors who were not involved are not liable.

There is no specific period prior to the commencement of the bankruptcy in which the relevant act must have been undertaken. The normal five years provisions for limitation of the DCC apply.

2.4 Extortionate credit transactions

There are general provisions on extortion in the Dutch Criminal Code and there are provisions in the Dutch Act on Consumer Loans. However, there are no provisions on extortionate credit transactions specifically relating to insolvencies. Extortionate credit transactions could also constitute transactions in fraud of the creditors (see also 4 below).

2.5 Fraud in anticipation of winding up

If managing directors entered into new contracts or if they enticed creditors to extend their existing credits by fraud in anticipation of a bankruptcy, this may give rise to civil liability (Beklamel-type of actions). Under certain circumstances, this type of fraud may also entail criminal liability, but prosecution is rare. In general this type of fraud will lead to liability of the managing director for the losses suffered by the creditor(s) concerned. Individual managing directors who were involved in the transaction will be jointly and severally liable irrespective of their degree of involvement. Managing directors who were not involved are not liable.

2.6 Breach of general / common law duties owed to the company

The duty of care of a director is primarily a duty owed to the company. Breach of duties owed to the company will result in civil liability toward the company. Such liability relates only to the loss caused by the breach of duty. When there has been mismanagement, which was an important cause of the bankruptcy, there may be liability for the entire deficit in the bankruptcy. Individual directors who were involved in or responsible for the breach will be jointly and severally liable irrespective of their share of involvement. Directors who were not involved and who were not responsible for the breach are not liable (unless there is mismanagement, which was an important cause of the bankruptcy).

There is a statutory limitation period of five years as from the time the breach of duty is discovered. With regard to mismanagement which was an important cause of the bankruptcy, such mismanagement should have occured in the 3 year period prior to the bankruptcy.

2.7 False representation to company's creditors

False representations to the company's creditors may give rise to managing director's liability based on tort. Criminal liability is rare in such cases. Generally speaking, only the managing directors who were actually involved will be liable; however, all those managing directors who were involved are jointly and severally liable[15]. If the false representation is based on false annual accounts (or similar documents), the management board is liable to all third parties that suffered damages due to these false annual accounts[16]. The supervisory directors are similarly liable in respect of the annual accounts[17].

The normal provisions for limitations apply (five years as from the date of discovery of the false representation).

2.8 Oppressive / unfairly prejudicial conduct against creditors

This is not a specific liability in a bankruptcy. Under certain circumstances, this could constitute a tort.

2.9 Conduct rendering a director unfit to be a director leading to disqualification

There is no legislation in the Netherlands that provides for procedures leading to general disqualification of a person to become or to be a managing director of companies.[18]

2.10 Incurring further credit during the twilight period

In general, incurring further credit in the period preceding bankruptcy does not result in personal liability for directors. It is, however, conceivable that such transactions sometimes also constitute transactions in fraud of creditors.

2.11 Fraudulent, dishonest, wrongful and negligent trading

A managing director may be personally liable in case of fraudulent, dishonest, wrongful or negligent trading. This is a general liability and not specifically related to bankruptcy law. However, if the fraudulent, dishonest, wrongful or negligent trading was an important cause of the bankruptcy, this may constitute mismanagement and may thereby lead to liability to the receiver in bankruptcy for the entire deficit in the bankruptcy and/or to the tax and social security authorities for taxes that have not been paid.

2.12 Preferences

Any transaction whereby the preferences are not being honoured may constitute a tort by the involved managing directors to the creditors whose interests were harmed. The liability that may arise is civil and not criminal.

The normal provisions for limitation apply (five years as from the date of discovery of the false representation). There are no specific defences apart from the normal defences that apply in any tort case.

2.13 Transactions at undervalue

Transactions at undervalue may lead to liability of the managing directors to the company, because of a breach of the duty of care of a managing

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15 articles 6:102 DCC
16 articles 2:139 and 2:249 DCC
17 articles 2:150 and 2:260 DCC
18 However, the Ministry of Justice is presently considering to include such provisions in Dutch law.

director[19]. Such transactions may also lead to liability based on tort to creditors whose interests were harmed. Transactions at undervalue could also constitute mismanagement and thereby lead to liability to the receiver in bankruptcy and/or the fiscal and social security authorities (see also 2.2. above).

Except for mismanagement, transactions at undervalue mentioned above are in principle individual liabilities.

The normal provisions for limitation apply (five years as from the date of discovery of the false representation). There are no specific defences apart from the normal defences that apply in any tort case.

QUESTION 3

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3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to liability resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Other persons liable in respect of the company's activities during the "twilight" period

In addition to the formally appointed managing directors, a *de facto* managing director may be liable if there is mismanagement which is an important cause of the bankruptcy. The liability of the *de facto* managing director is generally not different from the liability of a managing director.

Former managing directors may also be liable but only as regards the activities during the period in which they were active as managing director are concerned.

The liability of a person knowingly dealing with a managing director abusing his powers and that of third parties with knowledge of insolvency of the company is limited to the damage resulting from the actions they were involved in.

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[19] article 2:9 DCC

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Potential heads of challenge regarding transactions with the company

Actio Pauliana
Under the provisions of the Actio Pauliana, a legal act between the debtor-company and a third party, entered into prior to the bankruptcy, which is detrimental to the creditors, can be invalidated. For legal acts which the debtor company was not obligated to perform, the most important conditions for a successful Actio Pauliana include: the creditors of the debtor company must have suffered damages as a result of the transaction, and each of the debtor-company and the third party should have been aware of the fact that the transaction would be prejudicial to the creditors.

In respect of a transaction the debtor entered into within one year before the bankruptcy, the DBA provides for a shift of the burden of proof that there was knowledge that the transaction would be prejudicial to the interests of the creditors in certain types of transactions. These include transactions with insiders, transactions whereby the value of the transaction on the debtor's side substantially exceeds the value on the creditor's side, and transactions whereby the debtor provides security for a debt not yet due and payable[20].

For completeness sake it is noted that under certain strict conditions, legal acts which the debtor company was obligated to perform can be invalidated as well with the Actio Pauliana.[21]

General Tort
Under the general tort provision of the DCC, a party who has dealt with the debtor company may under certain circumstances be liable for damages.[22] The requirements for such liability are

(i) an act or omission which infringes another person's right, violates a legal obligation or breaches a duty of care,

(ii) which act can be attributed to said party,

(iii) damages and

[20] article 43 DBA
[21] article 47 DBA
[22] article 6:162

(iv) said damages having been caused by the unlawful act.

(v) If the third party is held liable under the general tort provision, the court will normally award damages but could also, upon request of the creditor, reverse the act and thereby set aside the transaction.

Extortionate credit transactions
Extortion in general may give rise to an action for cancellation of a legal act for misuse of circumstances. Apart from the cancellation of the legal act, misuse of circumstances can also lead to an amendment of the consequence of the act.

QUESTION 5

5. Enforcement

Who may bring an action against directors (and/or others identified in Question 3 above)?

Enforcement

Based on general tort, any third party can bring an action against the managing directors and others identified in question 3 above. This includes the receiver in bankruptcy, creditors, the shareholders, and others.

A receiver in bankruptcy can institute legal actions against the managing and supervisory directors and others identified in question 3 above for mismanagement if this was an important cause of the bankruptcy[23]. A receiver in bankruptcy can institute legal actions against the managing directors for a breach of their duty of care to the company.[24]

A third party can institute legal actions against the managing directors for any misrepresentation in the published (annual or interim) accounts or annual reports[25] or against the supervisory directors for any misrepresentation in the published annual accounts[26].

The tax collector and the social security authorities may institute legal actions against the managing directors for tax, social security and pension obligations.

The District Attorney (*"Officier van Justitie"*) can institute criminal proceedings against the managing directors.

The shareholders, the unions and the District Attorney may start proceedings before the entrepreneurial chamber of the court of appeal in Amsterdam,

23 articles 2:138 and 2:248 DCC
24 article 2:9 DCC
25 articles 2:139 and 2:249 DCC
26 articles 2:150 and 2:260 DCC

requesting that an investigation into the affairs of the company take place. If it appears from such an investigation that there has been mismanagement, the court has several options, including suspension or dismissal of all or some of the managing directors.

QUESTION 6

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6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 Managing directors and supervisory directors

If it is found that a managing or supervisory director did not properly perform his duties to the company, the court may award damages up to the amount equal to the monetary value of the loss suffered by the company as a result of the breach of duties[27]. The court may also decide, although in practice that hardly ever occurs, that the managing director take such measures to restore the company to the position it would have been in if the breach of duties had not occurred.

If it is established that there was mismanagement (either by a managing director or a supervisory director), and that such mismanagement was an important cause of the bankruptcy, the court may decide that the managing director and/or the supervisory director who can be blamed for that has to pay an amount of damages equal to the entire deficit in the bankruptcy[28].

In case of a tort, the court may award damages to the company or one or more creditors for the losses suffered as a result of the tort. It is possible but not very likely that the court decides that the managing director and/or supervisory director restore the injured party in the position in which it would have been had the tort not occurred[29].

If it is found that the published (annual or interim) accounts or annual reports of the company are misleading, the court may award the third party who relied on those accounts to his detriment with damages up to the amount of the losses suffered by the third party as a result thereof. The managing directors can be held liable for any misrepresentation in the published (annual or interim) accounts or annual reports, the supervisory directors only for any misrepresentation in the published annual accounts[30].

6.2 Other parties involved with the affairs of the company

In certain situations third parties may also be liable in connection with transactions of the company such as a parent company which creates a false

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27 article 2:9 DCC
28 articles 2:138, 2:149, 2:248 and 2:259 DCC
29 article 6:162 DCC
30 articles 2:139, 2:150, 2:249 and 2:260 DCC

picture of creditworthiness of a subsidiary that is actually bankrupt or third parties who are the counterpart in transactions that are later declared null and void because, for example, they were detrimental to the creditors. Depending on the nature of the transaction, it may either constitute a tort or the transaction may be declared null and void. If a transaction is found to be null and void, the parties to such transaction have to do whatever is necessary to restore the position in which they would have been if the act or transaction had not occurred. If this is not possible, such obligation may be replaced by an obligation to pay damages

If a tort has occurred the court may award damages to the injured party up to the amount of the losses suffered by injured party. The court may also decide, although this is not likely to occur in practice, that the party who committed the tort restores the injured party to the position it would have been in had the tort not occurred.

6.3 Remedies under the Dutch Criminal Code

Apart from general penalties for crimes and misdemeanours, the following provisions of the Dutch Criminal Code (*"Wetboek van strafrecht")* require attention:

The Dutch Criminal Code provides for punishment of the managing or supervisory director of a legal entity which has been declared bankrupt, up to one year imprisonment or a fine of the fifth category[31]:

- if he co-operated in or approved any act, in breach of any by-law, which in major part caused the losses suffered by the legal entity;
- if he, with the objective of postponing the bankruptcy while knowing that it was unavoidable, took care of or approved that the legal entity obtained credit on unfavourable terms;
- if it can be attributed to him that certain duties of the (board of the) legal entity regarding its administration have not been fulfilled or that such administration is not presented (to the receiver in bankruptcy) in a proper state.

The managing or supervisory director of a legal entity which has been declared bankrupt, will be punished by up to six years imprisonment or a fine of the fifth category[32], if, for the purpose of fraudulently causing detriment to the interests of the creditors of the legal entity, he:

- either fabricated obligations or failed to account for benefits, or took anything from the bankrupt estate;
- transferred assets from the bankrupt estate without consideration or evidently below value;
- in bankruptcy or at the time he knew that bankruptcy was inevitable, rendered an undue advantage to a creditor in anyway;
- did not fulfil his duties with regard to the maintenance of the administration of the legal entity pursuant to certain specific statutory provisions and with regard to the preservation and presentation of such

[31] article 342 Dutch Criminal Code
[32] article 343 Dutch Criminal Code

administration (to the receiver in bankruptcy) in a proper state.

The inside or outside director of a legal entity who, outside the scope of article 342 Dutch Criminal Code, took part in or approved any act, in breach of any by-law to the substantial detriment of the legal entity, will be punished by a fine of the fifth category[33].

QUESTION 7

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7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (in the UK and in other European jurisdictions, for example, Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

The bankrupt debtor is obliged to appear before the Supervisory Judge, the receiver in bankruptcy and the creditors' committee upon request and to provide all information requested[34]. In case the bankrupt debtor is a company, these obligations apply to (former) managing directors and (former) supervisory directors.

The provisions of the European Convention of Human Rights apply.

QUESTION 8

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8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether appeal is possible against the decision of the lower courts.

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[33] article 347 Dutch Criminal Code
[34] articles 105 and 106 DBA

In general, claims for damages under Dutch law are subject to a statutory limitation period of five years which commences when the injured person

(i) knows about the losses and

(ii) knows who is liable. This also applies to receivers in bankruptcy instituting a claim against the managing or supervisory directors of the bankrupt company for mismanagement[35].

Claims pursuant to the Actio Pauliana are subject to a statutory limitation period of three years which commences when the prejudice is discovered.

Except in cases of monetary insignificant claims it is possible to appeal to the appellate court against decisions of the lower courts in respect of the claims mentioned in this chapter.

QUESTION 9

9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

The legal provisions and procedures above also apply to foreign entities except that

(i) claims under Dutch law by the receiver in bankruptcy based on mismanagement which was an important cause of the bankruptcy are only allowed with respect to foreign entities which are subject to Dutch company tax and which have been declared bankrupt in the Netherlands and

(ii) claims for breach of duty vis-à-vis the company are governed by the law of incorporation.

See the Dutch Act on the conflicts of law for corporations (*"Wet Conflictenrecht Corporaties"*).

[35] articles 2:138, 2:149, 2:248 and 2:259 DCC

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

Directors' liability insurance is available and commonplace in the Netherlands. It provides a reasonable protection against possible liabilities. Although the covered amounts are not always sufficient, this is not as big a problem in practice as it may seem, because the court is able to limit the liability to the covered amounts. Also for that reason, settlements are often made directly between the insurer and the claiming parties, in which case the starting point of the negotiations is the maximum covered amount.

The insurance does normally not provide for coverage against the consequences of fraudulent behaviour of the director himself.

QUESTION 11

How safe is it for directors and others to incur further credit during the twilight period?

Further credit should only be incurred if there is no reasonable prospective that the obligation for repayment will not be satisfied (or, if the bank knowingly takes the risk of not being repaid). However, even if it is probable that the obligations for repayment will be met, the incurring of further credit may still be an improper action resulting in personal liability of a managing director if there is no reasonable justification for the company incurring further liabilities (which could result in less assets being available for the existing creditors).

NEW ZEALAND

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Overview

Transactions vulnerable to attack

1.1.1 The *Companies Act 1993* recognises that certain transactions entered into before the commencement of formal insolvency proceedings (liquidation of the company) could have the effect of unfairly advantaging one creditor at the expense of the company and its creditors in general. The Act[1] therefore contains provisions in sections 292 – 299 enabling a liquidator of the company to set aside certain transactions having preferential effect, voidable charges, transactions at an undervalue and transactions which appear to give an advantage to persons who have a special relationship with the company. A full description of these types of transaction can be found in Question 4.

The start and duration of the "twilight period' depends on the nature of the transaction and the identity of the parties to it.

1.1.2 The vulnerability periods for transactions entered into by a company before the commencement of formal insolvency proceedings (liquidation) which are vulnerable to attack are:

(a) Transactions having preferential effect (s.292) – 2 years

(b) Voidable charges (s.293) – 1 year

(c) Transactions at an undervalue (s.297) – 1 year

(d) Transactions for inadequate or excessive consideration with directors and certain related parties (s.298) – 3 years

(e) Securities and charges issued by the company in favour of directors and certain related parties (s.299) – no time limit.

[1] References to the Act and all section references in this paper are to the Companies Act 1993, unless otherwise stated.

1.1.3 In each case where the liquidation is initiated by resolution of the shareholders of the company, the period runs back from the date on which a liquidator is appointed to the company. However where either:

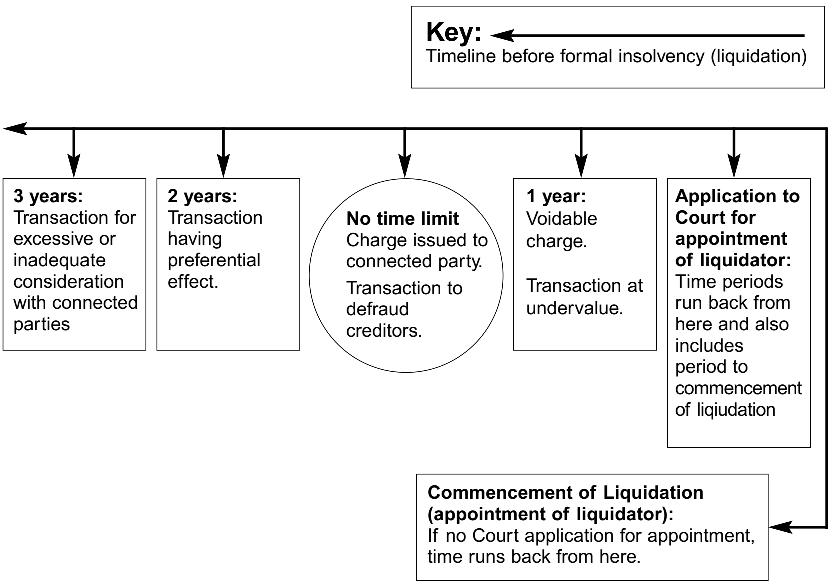
(a) the liquidator is appointed by the Court; or

(b) an application is made to the Court to put a company into liquidation and after the making of the application a liquidator is appointed by resolution of the shareholders of the company,

the period runs back from the date on which the application to the Court was made and **also** includes the period between the date on which the application was made and the date on which the liquidator is appointed.

1.1.4 The Property Law Act 1952 also contains a provision which has the effect of avoiding any transfer of property with intent to defraud creditors. The transaction is voidable at the instance of the person prejudiced. There is no time limit. However the transaction cannot be avoided if the property was transferred to a purchaser in good faith and for value who had no notice of the intention to defraud creditors.[2]

1.1.5 The following time line shows in graphic form the periods in respect of which certain types of transaction are vulnerable.



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[2] Section 60, Property Law Act 1952

1.1.6 Among the statutory duties of directors under New Zealand law are a duty not to agree or cause or allow the company to trade recklessly (s.135), and a duty not to agree to the company incurring an obligation unless the director believes on reasonable grounds that the company will be able to perform the obligation when it is required to (s.136). These issues are discussed in more detail at Question 2.

1.1.7 The Courts try to identify the time at which a director knew or should have realised that the company was trading while insolvent (i.e. creditors were likely to go unpaid in due course). A director will potentially be personally liable for all losses to creditors arising after that time.

QUESTION 2

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2 Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a):-

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

2.1 Insolvent Trading[3]

(a) The elements of insolvent trading are:

(i) It applies to directors, "de facto directors", "shadow directors" and "deemed directors"[4] of a company;

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[3] Section 136

[4] See paragraphs 3.2.1 - 3.2.12 below for a full explanation of these terms. For current purposes a "de-facto" director is someone who may not have been formerly appointed as a director but who acts in the same way as a director or is held out as such. A "shadow director" is someone in accordance with whose directions or instructions the directors of the company are accustomed to act. It will thus cover the "puppet master" who, for whatever reason, does not wish to appear on the face of the record as a director of the company but who in fact "pulls the strings" and tells the directors what to do. This would also include parent companies who in effect decide what their subsidiaries do.

(ii) A director has a duty not to agree to the company incurring an obligation, unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

(iii) The duty has a subjective element relating to the belief of the director, and an objective element, concerning the grounds on which the belief is based.

(iv) The section applies only in relation to directors who "agree" to the incurring of an obligation. Therefore directors who are not involved in the process of authorising the company's obligations might escape liability, at least in relation to this specific duty (as opposed to the statutory duty of care referred to later). However, the Courts generally use a very broad interpretation of "agree". Also, unless the company's constitution expressly states otherwise, a director who is at a directors' meeting is taken to have agreed to the company's assumption of obligations as resolved by the board at that meeting unless he or she expressly dissents from the resolution passed by the majority (Third Schedule of the Act).

(v) Breach of this duty does not confer any direct cause of action on the creditors of the company; only the company or a shareholder is able to apply for a statutory remedy.[5] However, if the company is placed in liquidation, a creditor may apply to the Court for an Order that a director pay compensation (although generally compensation would be paid to the liquidator for the benefit of all creditors) – section 301.

(b) (i) Liability is civil.

(ii) The Court has a wide discretion in determining the extent of the personal liability of a director found liable for insolvent trading. However, the essence of the law is to compensate creditors for the loss caused by the director's conduct. The trend of the cases is that the measure of damages broadly equates with most of the losses (or, sometimes, debt) incurred by the company after a date on which the Court considers the company was clearly insolvent and should have stopped trading.

(iii) Where more than one director is involved there is an element of proportionality, depending on the degree of involvement and culpability of the particular director and the duration that director was involved.

(iv) There is no specified period.

(v) For defences, refer to paragraph 2.3 below.

[5] Nicholson v Permakraft (NZ) Ltd [1985] 1 NZLR 242 CA

2.2 Reckless Trading

(a) The elements of reckless trading are:

(i) It applies to directors, “de facto directors”, “shadow directors” and “deemed directors” [7] of a company;

(ii) A director has a duty not to agree to, or cause or allow, the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors.

(iii) These concepts are objective and the director’s subjective belief would therefore not excuse breach of the duty.

(b) (i) Liability is civil.

(ii) The Court enjoys a wide discretion to compensate for the loss caused to the company by the director’s conduct - in exceptional cases it may also include a punitive element in the award of damages made.

(iii) As with insolvent trading, there is usually an element of proportionality, although the court’s discretion is very wide.

(iv) There is no specified period.

(v) For defences, refer to paragraph 2.3 below.

2.3 Defences to insolvent trading and reckless trading actions

The fact that a director has no knowledge of the company’s affairs will almost certainly not excuse a breach of duty.

A non-executive director may not be expected to have the same involvement in the company as an executive director (*AWA Limited v Daniels (1992) 10 ACLC 993*) . As a result of recent Australian cases, there is debate in New Zealand about whether, when it comes to responsibility for what has been done by the company, the same standards will be applied to both types of directors.

Reliance on information provided by others

When exercising powers or performing his or her duties, a director may rely on reports, statements, financial data and other information prepared or supplied by, and on professional or expert advice given by:

- an employee the director believes on reasonable grounds to be reliable and competent in a particular area;

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[6] Section 135

[7] See paragraphs 3.2.1 - 3.2.12 below for a full explanation of these terms. For current purposes a "de-facto" director is someone who may not have been formerly appointed as a director but who acts in the same way as a director or is held out as such. A "shadow director" is someone in accordance with whose directions or instructions the directors of the company are accustomed to act. It will thus cover the "puppet master" who, for whatever reason, does not wish to appear on the face of the record as a director of the company but who in fact "pulls the strings" and tells the directors what to do. This would also include parent companies who in effect decide what their subsidiaries do.

- a professional adviser or expert in relation to the matter believed on reasonable grounds to be within the person's competence; or
- any other director or committee of directors in relation to an area of designated authority (s.138).

In each case there is a requirement of subjective belief coupled with objective grounds for the belief.

Also, reliance is only permitted if the director:

- acts in good faith; and
- makes proper enquiry where the need for enquiry is indicated by the circumstances; and
- has no knowledge that such reliance is unwarranted.

Although the Act does not provide for the consequences of reliance by a director on information or advice provided by others, the implication appears to be that where a breach of duty has arisen as a result of incorrect advice or information given to the director, this reliance may be raised as a defence. Some matters will, however, require the director to exercise his or her own judgment, and in such cases it will not be permissible to pass responsibility on to someone else.

Delegation of Powers

A director may have a defence where the board of directors of the company has delegated relevant powers (including powers to enter into contracts and incur obligations) to a committee of directors, a director or an employee of the company. A board is able to delegate most of its powers (s.130).

A board that delegates a power is not responsible for the exercise of the power by the delegate if the board:

- believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise it in conformity with the duties imposed on directors by the Act and the company's constitution; and

- the board has monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

Where a power of the board has been properly delegated, the delegate will be regarded as a director for the purpose of duties imposed by the Act (s.126).

2.4 Liability to repay distributions made to shareholders[8]

(a) A board of a company may not authorise a distribution to shareholders unless the board is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the statutory solvency test.[9]

[8] Section 56 - A distribution to shareholders is defined in section 2(1) as:
(a) the direct or indirect transfer of money or property (other than the company's own shares) to or for the benefit of the shareholder; or
(b) the incurring of a debt to or for the benefit of the shareholder, in relation to shares held by that shareholder.

[9] A company satisfies the solvency test if:
(a) the company is able to pay its debts as they become due in the normal course of business; and
(b) the value of the company's assets is greater than the value of its liabilities including contingent liabilities (section 4).

Directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion.

A distribution made to a shareholder at a time when the company did not, immediately after the distribution, satisfy the solvency test may in certain circumstances be recovered from the shareholder. To the extent that a distribution is not able to be recovered from the shareholder (because the shareholder has no obligation to repay it, because the shareholder has insufficient assets or for any other reason), any director who failed to take reasonable steps to ensure the correct procedures for authorising distributions were followed, or who signed the solvency certificate when there were no reasonable grounds for believing at that time that the company would satisfy the solvency test, will be liable to the company to repay the distribution.

(b) (i) The liability is civil and in part criminal (a director commits an offence if he or she voted in favour of a distribution and fails to sign the solvency certificate – s.52(5)).

(ii) Civil liability is limited to repayment of so much of the distribution as cannot be recovered from shareholders. However, where a company could have satisfied the solvency test by making a distribution of a lesser amount, the Court in an action against a director or shareholder has the discretion to permit the shareholder to retain (or relieve the director from liability in respect of) an amount equal to the value of any distribution that could properly have been made.

(iii) Liability of the relevant directors concerned will be joint.

(iv) There is no specified period – the critical element is whether immediately after the distribution the solvency test was satisfied.

(v) A director has a defence if he or she can show that they took reasonable steps to ensure that the statutory procedure which is a prerequisite to authorising a dividend was followed, or that there were reasonable grounds to believe the company would satisfy the solvency test.

2.5 Liability if proper accounting records not kept[10]

(a) The board of directors of a company has statutory duties to cause adequate accounting records to be kept that correctly record and explain the transactions of the company and that will at any time enable the financial position of the company to be determined with reasonable accuracy. The board also has obligations to ensure that financial statements of the company comply with provisions of the Financial Reporting Act 1993 and to keep sufficient accounting records to enable the financial statements of the company to be readily and properly audited (section 194)

[10] Sections 194 and 300

(b) (i) The liability in relation to the duty is both criminal and civil. If the board fails to comply every director commits an offence.

(ii) If a company that is in liquidation is insolvent and there has been failure to

(iii) comply with these duties, and the Court considers that the failure to comply:

- contributed to the company's inability to pay all its debts; or
- has resulted in substantial uncertainty as to the assets and liabilities of the company; or
- has substantially impeded the orderly liquidation; or
  for any other reason it is proper to make a declaration,

the Court on the application of a liquidator, may declare that any one or more of the directors or former directors are personally responsible for all or any part of the debts and other liabilities of the company. The liability may be joint or proportional.

(iv) There is no specified period.

(v) In relation to the civil liability, the director has a defence if he or she can satisfy the Court that he or she:

- took all reasonable steps to secure compliance by the company with the provision; or
- had reasonable grounds to believe and did believe that a competent and reliable person was charged with the duty, and was in a position to discharge the duty.

In relation to criminal liability a director charged with an offence concerning a duty imposed on the board of a company has a defence if the director proves that:

- he or she took all reasonable and proper steps to ensure that the board complied with the duty; or
- the board took all reasonable and proper steps to ensure that the duty would be complied with; or
- in the circumstances he or she could not reasonably have been expected to take steps to ensure that the board complied with the duty (s.376).

2.6 Wrongdoing[11]

(a) (i) This liability applies to directors, "de facto directors", "shadow directors" and certain types of "deemed director".

[11] Section 301

(ii) A past or present director of the company who has misapplied or retained, or become liable or accountable for, any money or other property of the company, or has been guilty of negligence, default or breach of any duty or trust in relation to the company, will incur liability.

(b) (i) The liability under the section (s.301) is civil.

(ii) The Court has a discretion to order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the Court sees fit, or to contribute such sum to the company's assets by way of compensation in respect of the negligence, default or breach of duty as the Court thinks fit.

(iii) The Court has wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability. It may also make some or all of the directors jointly and severally liable for the compensation – in this case directors will enjoy rights of contribution from other directors also found responsible for the same loss.

(iv) Apart from Limitation Act 1950 considerations, there is no time period within which the impugned act must have occurred in order for liability to attach.

(v) There are no specific statutory defences to an action against directors under these heads. The Court however has considerable discretion as to quantum of any order against the director.

2.7 Liability in relation to other statutory duties under the Act

Liability to the company or to shareholders?

One of the aims of the Companies Act 1993 was to make the nature and scope of directors' duties more generally accessible. The Act therefore contains in sections 131 – 149 a restatement of many of the duties previously found in the general law. The statutory duties in sections 131 – 149 are duties of a fiduciary nature which accompany the office of director.

Duties owed to the company:[12] include

- to act in good faith in the best interests of the company [13](s.131).
- to exercise powers for a proper purpose (s.133)
- not to trade recklessly (s.135) - see paragraph 2.2 above
- not to agree to certain obligations (s.136) – see paragraph 2.1 above
- to exercise care (s.137) – see below
- duties relating to disclosure of company information and the use of that information (s.145)

[12] Section 169

[13] In certain circumstances the constitution of a subsidiary may permit, the directors to act in the best interests of the holding company if the other shareholders consent, and if the constitution of a joint venture company permits, directors of joint ventures may act in the best interests of the shareholder that appointed them.

Duties owed to shareholders[14] include:

- to disclose interests and dealings in the company's shares (ss.140 & 148)

Duties owed to both company and shareholders include the duty to comply with the Act and the company's constitution (s.134).

Directors also have many administrative duties under the Act, and additional duties may be imposed by the constitution of the company or by a specific contract with a director.

Liability to creditors?

Directors are not liable to creditors as fiduciaries, or for negligence in the management of the company. Creditors therefore are not entitled to interfere in the company's affairs while it remains solvent.

However, under the general law, where a company is insolvent directors are obliged to take creditors interests into account because it is the creditors' rather than the shareholders' money at risk. *(Nicholson v Permakraft (NZ) Limited* [1985] 1 NZLR 242, *Hilton International Limited v Hilton [1989]* 1 NZLR 442). This rule is also said to apply where there is a "real risk" of insolvency. The Companies Act 1993 imposes on directors no express duty to creditors. New Zealand Courts are likely to follow English and Australian Courts which have reaffirmed there is no fiduciary duty to creditors, and that the statutory duties require enforcement under the statutory scheme. However, where the company is insolvent or near insolvency, shareholders are unable to ratify breaches by directors of duties owed to the company such as the duty not to permit insolvent trading and not to trade recklessly *(Ukon Line Limited of Korea* [1998] 2 BCLC 485, and *Spies v The Queen* [2000] 8 HCA 43).

The duty to exercise care (section 137)

The standard of care that applies to a director when carrying out his or her duties is the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation:

- the nature of the company;
- the nature of the decision; and
- the position of the director and the nature of the responsibilities undertaken by him or her.

2.8 Carrying on business fraudulently[15]

(a) A director (or any other person) who is knowingly a party to a company carrying on business with intent to defraud creditors of the company or any other person or for a fraudulent purpose, commits an offence.

[14] Section 169
[15] Section 380

Also, every director commits an offence who:

(i) by false pretences or other fraud induces a person to give credit to the company; or

(ii) with intent to defraud creditors of the company:

- gives, transfers or causes a charge to be given on property of the company; or
- causes property to be given or transferred to any person; or
- caused or was a party to execution being levied against property of the company.

(b) (i) Liability is criminal, but may also be civil (see paragraph 2.6).

(ii) A person guilty of these offences is liable to imprisonment or a fine, and is automatically prohibited from being a director of or managing a company for 5 years without leave of the Court (s.382).

(iii) The gravity of the wrongdoing will be reflected in the length of imprisonment or the amount of the fine. In exercising its punitive jurisdiction under this section, the Court is not seeking to compensate the company.

(iv) There is no specified period.

(v) Absence of intent to defraud a creditor or the creditors of the company (as applicable) amounts to a defence.

2.9 Avoidance or obstruction[16]

(a) A director of a company (or any other person) commits an offence if he or she:

(i) Leaves New Zealand with the intention of:

- avoiding payment of money due to the company; or
- avoiding examination in relation to the affairs of the company; or
- avoiding compliance with an order of the Court, or some other statutory obligation in relation to the liquidation and affairs of the company

(ii) conceals or removes property of the company with the intention of preventing or delaying the liquidator taking custody or control of it; or

(iii) destroys, conceals or removes records or other documents of the company.

(b) (i) Liability is criminal (there may also be civil liability – refer paragraph 2.6) and the answers to 2.8 (b) (ii) and (iii) will apply – except that there is no automatic prohibition from being a director or manager.

[16] Section 273

(ii) The acts in question must have occurred either after the company has gone into liquidation or after an application has been made to the Court for an order that the company be put into liquidation.

2.10 Failure to identify and deliver property to a liquidator[17]

(a) A present or former director of a company in liquidation commits an offence if he or she:

(i) fails to promptly give the liquidator details of property of the company in his or her possession or under his or her control; or

(ii) fails to, at the liquidators request, deliver property to the liquidator or as directed, or dispose of the property as directed.

(b) (i) Liability is criminal (there may also be civil liability – refer paragraph 2.6) and the answers to 2.8 (b) (ii) and (iii) will apply – except that there is no automatic prohibition from being a director or manager.

(ii) The specified period is during the liquidation of the company.

2.11 Other actions giving rise to liability for directors

(a) (i) Directors can be held liable under the Act in a number of other situations.

These include:

- in respect of a document required by or for the purposes of the Act and in certain other circumstances, making false or misleading statements, or omitting from a document something which makes the document false or misleading in a material particular, or authorising this (s.377);

- fraudulently taking or applying company property for a use or purpose other than the use or purpose of the company, or fraudulently concealing or destroying the property of the company (s.378);

- destroying, mutilating, altering or falsifying any document belonging to or relating to the company, or making a false entry in any such document, or being a party to those acts (s.379);

(b) (i) Liability of a director is criminal.

(ii) The Act sets out maximum penalties for each type of offence – these are imprisonment or a fine. The director also is automatically prohibited from being a director of or managing a company for 5 years without leave of the Court (s.382).

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[17] Section 274

(iii) There is no specified period before commencement of a subsequent insolvency procedure in which the relevant act (or omission) must have been done in order for liability to attach to a director. Further it is not necessary to show that the company was insolvent at the time.

2.12 Liability of directors under the Fair Trading Act 1986

(a) Sometimes directors make untrue or misleading representations to creditors about the financial position of the company in an endeavour to induce those creditors to make further supply at a time when the company is insolvent. If those creditors subsequently suffer loss, the directors may be personally liable to creditors under the Fair Trading Act 1986.

The actions of the directors can constitute misleading or deceptive conduct in trade. A number of recent New Zealand Court decisions have held that where the directors are the source of the information or misrepresentation and not a mere conduit of information, and were responsible for the manner in which the company's business was conducted with suppliers and other creditors, those directors can be held personally liable for the representations, irrespective of whether the representations were made on behalf of the company rather than in a personal capacity. See for example *Hill Country Beef NZ Limited* v *Sharplin* (High Court, Napier CP5/95, 28.3.96) and *Borrie v Specialist Livestock Imports Limited & Others* (High Court, Auckland CP381/97, 4.6.00).

(b) (i) The liability is civil;

(ii) The director making the representation will be personally liable for the loss suffered by the particular creditor as a result of the misrepresentation;

(iii) There is no specified period, but generally the company will need to be in financial difficulties.

2.13 Liability of directors to disqualification for acts done in the 'twilight zone'

2.13.1 The Registrar of Companies can prohibit any person who within the previous five years has been a director of, or concerned in or taken part in the management of, a company which becomes insolvent or which enters into a compromise or arrangement with its creditors, from being a director or promoter of a company (or being concerned in, or taking part, whether directly or indirectly in the management of, a company) for a period up to 5 years (s.385).

2.13.2 If a person becomes involved in the management of a company during the prohibition period, that person will automatically be personally liable to a liquidator of the company for every unpaid debt incurred by the company (and to a creditor of the company for a debt to that creditor incurred by the company), while the person was so acting. The person also commits an offence and on conviction is liable to a substantial fine or prison term (ss.385 & 386).

2.13.3 A person who has done any of the following things can be disqualified by the Court from being a director or promoter of, or in any way, whether directly or indirectly, being concerned in or taking part in the management of, a company for a period of up to 10 years, without leave of the court:

(a) While a director of a company and whether convicted or not

- persistently failed to comply with the Act, or the Securities Act 1978 (dealing with the issue of securities to the public) or, where the company has failed to comply, persistently failed to take all reasonable steps to obtain such compliance; or
- been guilty of fraud in relation to the company or of a breach of duty to the company, or a shareholder; or
- acted in a reckless or incompetent manner in the performance of his or her duties; or
- committed an offence under the Act

(b) been convicted of an offence in connection with the promotion, formation or management of a company, or a crime involving dishonesty.

(c) is held by a Court to be guilty of insider trading of a company's shares.

Applications to the Court for disqualifying a person can be made by the Registrar of Companies, the liquidator of the company or a creditor of the company (s.383).

2.13.4 Directors (and others) convicted of certain offences, or who have been found guilty of insider trading, are automatically disqualified from being directors of companies for a period of 5 years unless they obtain the leave of the Court (s.382).

The persons affected are those who:

- have been convicted on indictment of any offence in connection with the promotion, formation, or management of a company; or
- have been convicted of certain offences under the Act (those referred to in paragraphs 2.8 & 2.11 above), or any crime involving dishonesty; or
- are held by a Court to be guilty of insider trading of a company's shares.

2.13.5 Failure to seek leave of the Court constitutes an offence and exposes a director to personal liability for unpaid debts incurred by the company while the person acted without leave (s.382 and 384).

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in Question 2?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Introduction

3.1.1 Subject to the particular act or offence in question, New Zealand law may impose liability on a potentially wide variety of persons who have been involved in the management of a company in some way during the twilight period.

3.1.2 Although the management of a company's affairs is primarily undertaken by its directors, New Zealand law has an extended definition of this term[18] which is capable of including a variety of persons who, while not formally appointed as directors, may have played a role in the company's management during the twilight period and who may be held liable in respect of certain acts of the company during this time. In particular, New Zealand law will impose liability on "shadow", "de facto" and "deemed" directors in certain circumstances - these concepts are explained in Section 3.2 of this paper.

3.1.3 Also, other persons, even if not involved either directly or indirectly with the management of the company, may be liable to return assets to the company as a result of being a party to a transaction at undervalue, a preference or a transaction defrauding creditors. In addition, under general equitable principles of New Zealand law, a third party who had knowledge of a breach of duty of a director when entering into a transaction and either knowingly assisted in that breach and/or received property from the company with knowledge of that breach may be held liable as a "constructive" trustee of such property and liable to return it or to pay compensation to the company.

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[18] Section 126

3.2 De facto directors, shadow directors and deemed directors

3.2.1 The Companies Act 1993 contains an extremely wide definition of "director". Some categories of the definition apply only for the purposes of certain sections of the Act. Although the definition is not exhaustive of the meaning of the term "director", because of the comprehensive nature of the definition there does not seem much scope for including any other persons. Any person who is responsible for management decisions of the company will fall within one or more legs of the definition. Receivers of companies (appointed by secured creditors or by the Court) are excluded from the definition.

A brief description of the categories of "director" follows.

De facto directors

3.2.2 A "de facto" director is one who acts as a director and is treated as such by the rest of the board, even though he or she may never have been formally appointed a director or there is a defect in the technicalities of his or her appointment (for example he or she was appointed at a board meeting at which a quorum was not present).

3.2.3 "Director" is defined in section 126(a) of the Act to include any person occupying the position of director, by whatever name called. Thus, if someone were to be called an "observer" on the board but in fact took director-type decisions, the court may be prepared to conclude that that person is a de facto director.

3.2.4 De facto directors owe the same duties to the company as directors who have been formally appointed.

Shadow directors

3.2.5 The term "shadow director" is generally used to describe a person in accordance with whose directions or instructions a director, or the board of directors, of a company may be required or are accustomed to act, and a person who exercises or who is entitled to exercise or who controls or is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board (s.126(1)(b)).

3.2.6 There are a number of elements to note in the definition:

Person	can mean an individual or a corporation
Directions or instructions	these are clearly more than mere suggestions but may include non-professional advice in certain circumstances
Accustomed to act	there must be a pattern to the directions or instructions and occasional directions will not make someone a shadow director. However, again, the point at which conduct becomes habitual will depend upon the facts of a particular case

In practice, what conduct makes someone a shadow director?

3.2.7 In each case regard must be had to the frequency of the advice or instructions (whether over the running of the business as a whole or merely on specific areas) and whether such advice was usually acted upon (whether or not the directors have expressly or impliedly surrendered their discretion), so that it may be said that the third party in question exerted a real influence over the affairs of the company.

Deemed Directors

3.2.8 A person to whom a power or duty of directors has been directly delegated by the board with that person's consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board, is treated as being a director for many purposes of the Act (s.126(1)(c)).

3.2.9 Any person in accordance with whose directions or instructions a shadow director, de facto director or the person referred to in the preceding paragraph may be required or is accustomed to act in respect of his or her duties and powers as a director, is also treated as a director. However this is only for the purposes of directors' duties relating to the use of company information and disclosure of and restrictions on share dealings by directors.

Shareholders as deemed directors

3.2.10 If the constitution of a company confers a power on the shareholders which would otherwise fall to be exercised by the board of directors, any shareholder who exercises that power or who takes part in deciding whether to exercise it is treated, in relation to the exercise of the power, as being a director for certain purposes. This also applies where shareholders are involved in decisions in situations where the constitution of a company requires a director or the board of the company to exercise or refrain from exercising a power in accordance with a decision or direction of shareholders (s.126(2) & (3)).

Professional Advisers

3.2.11 Where a person advising a company acts purely in a professional capacity, that person is not included in the definition of director (unless occupying the position of director, by whatever name called, or unless the person is a shareholder exercising a power normally exercised by the board) (s.126(4)).

Disqualified Persons

3.2.12 A person acting as a director or taking part in the management of a company while disqualified from doing so may become personally liable for the company's debts (ss. 384 & 386).

3.3 Actions for which liability may attach to de facto, shadow or deemed directors and other persons not formally appointed as directors

Offence/activity	Persons liable	Extent of liability
Insolvent and Reckless Trading and other statutory duties (ss.131 – 141)	Past director and past and present de facto, shadow and certain deemed directors, during the relevant period.	Same as for director
Fraudulent trading (s.380 and s.373(4)(f))	Any person who was knowingly a party to the carrying on of the business with intent to defraud creditors or others or for a fraudulent purpose (this will include persons dealing with the company who receive property with knowledge of the fraud)	Same as for director
Failure to keep proper accounting records (ss 194 and 300)	Past directors for the relevant period	Same as for director
Leaving New Zealand or concealing destroying or removing property (ss.273 and s.373(3)(a))	Any person	Same as for director
Failure to identify or deliver company property (ss.274 & 373(3)(a))	Past director and past or present employee	Same as for director
Wrongdoing – negligence or default or breach of duty (s.301)	Any past director; past or present de facto, shadow and certain deemed directors; liquidator; manager; receiver; any person involved in the formation or promotion of the company	Same as for director
Acting as a director or taking part in management of the company when disqualified (s.384 and s.386)	Any person	All debts incurred by the company during that period.

3.4 Other third parties who may be held liable to the company or its liquidator

3.4.1 Liquidators and receivers may be found liable for negligence, default or breach of duty owed to the company (s.301).

3.4.2 Third parties who receive property as a result of a transaction at undervalue, a transaction having preferential effect or (if that party has the requisite knowledge or is a volunteer) as a result of a transaction defrauding creditors, will be liable to either return such property or provide such compensation as the court may order.

3.4.3 It is also possible for any third party who has knowingly assisted in a breach of duty by a director or other officer of a company or knowingly received property arising from such breach to be liable in respect of any loss arising. The legal rules relating to knowing assistance and/or receipt of property are applicable in any circumstance and not only in respect of actions taken during the twilight period. The power of the Court to apply these rules arises under its general equitable jurisdiction.

Offence/activity	**Persons liable**	**Extent of liability**
Transaction at undervalue (s.297)	Recipient of property.	Pay compensation to the company
Transactions having preferential effect (ss. 292 & 293)	Recipient of preference or charge	Return of property received or removal of specific benefit received or payment of an amount fairly representing benefit received
Transactions for inadequate or excessive consideration with connected parties. (s.298)	Other party to transaction	Pay compensation to the company
Voidable charges (s.293) and charges issued to connected parties(s.299)	Recipient of charge	Setting aside of charge
Transaction defrauding creditors (s.60 Property Law Act 1952)	Recipient of property (if knowledge of fraud or volunteer)	Return of property received (or compensation if property disposed of)
Knowingly assisting or receiving property or assets in breach of duty	Any person with the requisite degree of "knowledge" who knowingly assists in a breach of duty owed by a person to a company or knowingly receives property from a breach of duty owed to the company	Where requisite knowledge and other applicable conditions are satisfied a person may be held to be a constructive trustee of the property and required to return such property or pay compensation equal to the loss caused. A director's liability arises directly as a result of the breach of duty. Knowledge or dishonesty not required

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter party seeking to protect a transaction from being attacked?

4.1 Summary of heads of challenge

4.1.1 Brief details of those types of transaction entered into by a company before the commencement of formal insolvency proceedings which are vulnerable to attack are transactions:

(a) which are at an undervalue;

(b) which have preferential effect;

(c) which constitute voidable charges;

(d) for inadequate or excessive consideration with directors or other related parties;

(e) which are securities or charges issued by the company in favour of directors or other related parties;

(f) in breach of the directors' fiduciary duties;

(g) defrauding the company;

(h) or which involve the following elements:

(i) onerous property;

(j) unregistered charges.

We look briefly at each head of challenge in turn.

4.2 Transactions at an undervalue (section 297)

4.2.1 A transaction is at undervalue if the value received by the company was less than the value provided by the company and, when the transaction was entered into, the company:

(i) was unable to pay its due debts; or

(ii) was engaged, or about to engage, in business for which its financial resources were unreasonably small; or

(iii) incurred an obligation knowing that the company would not be able to perform it; or

(iv) became unable to pay its due debts as a result of the transaction.

4.2.2 If the company is put into liquidation, a liquidator can recover from the counterparty to the transaction the amount by which the value of the consideration or benefit provided by the company exceeded the value of the consideration or benefit received by the company. The liquidator can only do this in respect of transactions:

(i) where the liquidator can establish the counterparty to the transaction knew or ought to have known of the relevant factor referred to in paragraph 4.2.1; and

(ii) the company entered into within a year before liquidation (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of this vulnerability period).

4.2.3 "Transaction" is defined in section 297 as including the giving of a guarantee by the company. It is thought that the New Zealand Courts will also use the definition of transaction contained in the section dealing with transactions having preferential effect (refer paragraph 4.3.4).

4.2.4 However, the term "transaction" does not include bilateral netting (set-off) agreements, or certain multilateral netting agreements which are subject to the rules of a recognised clearing house, entered into by the company – except to the extent that the effect of entering into the netting agreement is to reduce any amount that was owing by or to the company at the time the company entered into the agreement (s.310G).

4.2.5 A guarantee by a company to a bank of the liabilities of a parent or sister company might be a classic example of an undervalue transaction - if, say, the idea is simply to use the company to benefit its financially troubled parent or sister company. In relation to guarantees, there is no authority on the test to apply to ascertain the value provided by the guarantor and provided by the bank.

4.2.6 In practice, liquidators have found it difficult to use section 297 to set aside transactions. This is because the section focuses on whether the counterparty to the transaction knew or ought to have known of the company's precarious financial position at the time of the transaction – the onus is on the liquidator to establish this.

4.3 Transactions having preferential effect (section 292)

4.3.1 A transaction having preferential effect is a transaction entered into by the company at a time when it was unable to pay its due debts, and which enables another person to receive more towards satisfaction of the debt than the person would otherwise have received or be likely to have received in the liquidation – unless the transaction took place in the ordinary course of business.

4.3.2 If the company is put into liquidation, a liquidator can recover from the counterparty to the transaction an amount which fairly represents the benefits received by the party (for example, if the transaction was the payment of a debt, an amount equivalent to the payment), or in some cases property which was transferred to that party as part of the transaction. The liquidator can only do this in respect of transactions the company entered into within two years before liquidation (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of this vulnerability period).

4.3.3 If the transaction was entered into within six months before liquidation, there is a statutory presumption that the transaction was made at a time when the company was unable to pay its due debts, and that the transaction was not in the ordinary course of business. The onus of rebutting these presumptions is on the counterparty to the transaction. That party does not have to rebut both presumptions – rebuttal of either will mean the transaction cannot be avoided by the liquidator.

4.3.4 Transaction" is widely defined. It includes the incurring of any obligation by the company, the giving of a security or charge over the property of the company, and the payment of money by the company under a judgment or order of the Court. The transaction must be a transaction of the company. The New Zealand Courts have held that the transaction must be with a creditor of the company.

4.3.5 However, the term "transaction" does not include bilateral netting (set-off) agreements, or certain multilateral netting agreements which are subject to the rules of a recognised clearing house, entered into by the company – except to the extent that the effect of entering into the netting agreement is to reduce any amount that was owing by or to the company at the time the company entered into the agreement (s.310G).

4.3.6 The meaning of the expression "the ordinary course of business" has been the subject of a considerable amount of judicial interpretation (some of which has been in conflict). Factors which generally indicate that a transaction is outside the ordinary course of business include:

(1) Payment is atypically prompt or large compared with the established patterns;

(2) The conduct of the company is suggestive of a response to abnormal financial conditions;

(3) Putting pressure on the company to pay (indicates abnormal circumstances);

(4) The creditor has departed from its normal practice of recovering debt;

(5) Lump sum payments or the use of postdated cheques (where this is not usual practice).

4.3.7 For a transaction to be within the ordinary course of business, the creditor or liquidator (as the case may be) needs to show that there was nothing abnormal – nothing out of the ordinary – about the transaction in the commercial context in which it took place. The transaction must be such that in its actual setting it would be viewed by an objective observer as having taken place in the ordinary course of business. While there can be reference to business practice in the commercial world in general, the focus must still be the ordinary operational activities of businesses as going concerns, not responses to abnormal financial difficulty. *(Countrywide Banking Corporation Limited v Dean [1998] 1 NZLR 385 (Privy Council); Re Excel Freight Limited (In Liquidation) (Court of Appeal 5 March 2001).*

4.3.8 Intention on the part of the company to prefer the counterparty is irrelevant unless that intent was actually known to the other party. If known, the intent is only one of the factors to be taken into account (s.292(4)).

4.3.9 Generally speaking, where a liquidator has recovered any amount from a counterparty in relation to a transaction having preferential effect, the counterparty is able to prove as a creditor in the liquidation for an amount equivalent to the sum or value of the property the liquidator recovered.

4.4 Voidable Charges (section 293)

4.4.1 Any charge given by the company is voidable against the liquidator of the company if given within 1 year before liquidation (see paragraphs 1.1.2 & 1.1.3) unless:

(1) (and only to the extent that) the charge secures money actually advanced or paid, or the actual price or value of property sold or supplied to the company, or any other valuable consideration given in good faith by the recipient of the charge at the time of, or at any time after, the giving of the charge[19]; or

(2) immediately after the charge was given the company was able to pay its due debts; or

(3) the charge is in substitution for a charge given before the 1 year period (but only to the extent that the amount secured does not exceed the amount secured by the previous charge and the value of the property charged does not exceed the value of the property subject to the previous charge)

4.4.2 If the charge was given within six months before liquidation, there is a statutory presumption that immediately after the charge was given the company was unable to pay its due debts.

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[19] A charge given to secure the unpaid purchase price of property, whether or not the charge is given over that property, will be valid so long as it is executed not later than 30 days after the sale of the property.

4.4.3 Section 293, which is in addition to the provisions dealing with transactions having preferential effect, is specifically aimed at preventing creditors from obtaining security for past debts. It is not designed to impugn security given for new credit. To further give effect to this objective, section 293 includes a provision that all payments received by the grantee of a charge after it was given will be treated as being appropriated as far as may be necessary towards repayment of money actually advanced or paid (or payment of the actual price or value of property sold) by the grantee to the company on or after the giving of the charge.

4.4.4 Case law has made it clear that simply forbearing to sue for past debts will not be valuable consideration given in good faith by the chargeholder for purposes of this section, unless the forbearance can be shown to have some reasonable value or worth to the debtor *(Meo & Anor v The Official Assignee* (1987) 3 NZCLC 100,206, Court of Appeal).

4.5 Transactions for inadequate or excessive consideration with directors or related parties (section 298)

4.5.1 Where a company which subsequently goes into liquidation has acquired any business, property or services from a director or other specified related parties, the liquidator can recover from those parties the amount by which the value of the consideration given by the company exceeded the value of the business, property or services received. Also, where the company has disposed of a business or property or provided services or issued shares to directors or specified related parties, the liquidator can recover from those parties any amount by which the value of the items provided exceeded the consideration received by the company.

4.5.2 The liquidator can only do this in respect of transactions the company entered into within a period of three years before liquidation (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of this vulnerability period).

4.5.3 There is no need to establish whether the company was insolvent before or as a result of the transaction.

4.5.4 The categories of related parties from whom recovery is possible are extensive. They include a nominee or relative or a trustee for a director, a person or relative of a person who at the time had control of the company, related companies and companies controlled by a director of the company or by a nominee, relative or trustee of a director.

4.6 Securities and charges issued by the company in favour of directors or related parties (section 299)

4.6.1 Where a company goes into liquidation, a liquidator can apply to the Court to have a security or charge created by the company in favour of a director or other specified related parties set aside. The categories of related parties under this section are the same as under section 298 (see paragraph 4.5.4).

4.6.2 The Court can order a security or charge to be set aside if it considers it just and equitable to do so, having regard to the circumstances in which the security or charge was created, the conduct of the other party in relation to the affairs of the company, and any other relevant circumstances.

4.6.3 There is no need to establish whether the company was insolvent before the security or charge was issued. There is no specified time period.

4.6.4 If the security or charge is set aside, the related party will remain a creditor of the company for the amount owing under the security or charge.

4.6.5 This provision gives the liquidator, through the Court, the ability to have securities in favour of related parties set aside which cannot be set aside under section 292 (transactions having preferential effect – see Section 4.3 of this paper) or section 293 (voidable charges – see Section 4.4 of this paper). Although there have been no reported New Zealand decisions on this section, it is thought that a Court would be slow to set aside a security if it had been issued in respect of a bona fide commercial transaction with no intention of defeating creditors..

4.7 Defences available to a counter-party (s.296(3))

4.7.1 Even though a transaction may be a transaction at an undervalue, a transaction having preferential effect or a type of transaction referred to in Sections 4.4 – 4.6 of this paper, the Courts may deny recovery by the liquidator of property or its equivalent value from the counterparty, in whole or in part, if:

(1) The person from whom recovery is sought received the property in good faith and has altered his or her position in the reasonably held belief that the transfer to that person was validly made and would not be set aside; and

(2) In the opinion of the Court it is inequitable to order recovery or recovery in full.

4.7.2 The test of good faith appears to be one of simple honesty (*Re Excel Freight Limited (In Liquidation)* (1999) 8 NZCLC 261,827). An awareness of financial difficulty of the company is not in itself sufficient to give rise to a conclusion that any actions were not taken in good faith (*Re Island Bay Masonry Limited (In Liquidation)* (1998) 8 NZCLC 261,751).

4.7.3 To alter position, a counterparty must have deliberately taken or omitted some action in reliance on the apparent validity of the transaction. Examples of alteration of position would be to continue to supply and provide further credit.

4.7.4 The Court has considerable discretion about whether to deny the liquidator recovery. The concept of inequity carries the connotation of unfair or unjust. The Court will look at the overall circumstances and do what the justice of the case requires, having regard to the objective of the insolvency regime to ensure that creditors of an insolvent company of the same class are treated equally.

4.8 Breach by directors of general/common law duties

4.8.1 If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general common law duty to put the company's interests first. Where the counterparty has knowledge of this, there may be circumstances where there are proprietary or restitutionary rights to recover the property. These are rights under the general law and whilst not dependent upon insolvency as such, they are more likely to be examined and/or exercised after a formal insolvency event.[20]

4.9 Transactions with the intent to defraud creditors[21]

4.9.1 Where a company transfers property with intent to defraud creditors, that transfer is voidable at the instance of the person prejudiced.

4.9.2 There is no statutory time limit.

4.9.3 If the property is transferred to a purchaser who purchases for value in good faith and at the time of the transfer without notice of the intention to defraud creditors, the property cannot be recovered.

4.10 Disclaimer of onerous property (section 269)

4.10.1 When a company is in liquidation, the liquidator may disclaim any onerous property even though he or she has taken possession of it, tried to sell it, or otherwise exercised rights of ownership in respect of it. The liquidator must give prompt notice of disclaimer to every person whose rights are, to the knowledge of the liquidator, affected by the disclaimer.

4.10.2 Onerous property means (a) any unprofitable contract; and (b) any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform an onerous act. It does not include certain netting agreements[22] or any contract of the company that constitutes a transaction under a netting agreement. An example of onerous property would be a lease under which the company was the tenant and where the rent was greater than a market rent.

4.10.3 Where the counterparty has a proprietary as opposed to a personal interest in the property, there can be no disclaimer: for example, where the company is selling land, contracts have been exchanged and the buyer tenders the purchase price, the buyer is likely to be able to obtain specific performance of such a contract.

4.10.4 The disclaimer does not affect rights and liabilities already accrued. It determines, as from its date, the future rights interests and liabilities of the company in or in respect of the property disclaimed. The disclaimer does not (except so far as necessary for the purpose of releasing the company from any liability) affect the rights or liabilities of any other person. Any person

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[20] See generally discussion of directors duties in answer to Question 2

[21] Section 60 Property Law Act 1952

[22] See paragraph 4.2.4 for an explanation of this expression.

sustaining loss or damage as a consequence of the disclaimer is deemed to be a creditor of the company to the extent of such loss or damage and may prove as such.

4.10.5 A person whose rights would be affected by the disclaimer of onerous property may require a liquidator to elect whether to disclaim that property – if the liquidator does not do so within a stated period after receiving notice of the requirement, the liquidator will be unable to disclaim the onerous property in the future.

4.11 Failure to register a charge

4.11.1 The Personal Property Securities Act 1999 came into force on 1 May 2002. This Act replaced all existing legislation in relation to securities and registration of securities, over almost all types of personal property issued by any person (including companies). The Act introduced the concept of a *security interest*, which is widely defined as an interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation, without regard to either the form of the transaction or the identity of the person who has a title to the personal property. The definition therefore covers finance leases, retention of title rights and goods supplied on consignment.

4.11.2 The Act provides for the establishment of a Register of security interests in personal property and contains rules for the determination of priority between security interests in the same personal property. It also contains rules for the determination of priority between security interests and other types of interests in the same personal property, and a regime for the enforcement of security interests.

4.11.3 Under legislation repealed by the Act, charges given by companies over their property were, generally speaking, void against a liquidator or a creditor unless the charge was registered within a prescribed time period. Under the Personal Property Securities Act, unregistered security interests will not be void against a liquidator or any creditor of the Company. If a security interest is not registered, the only consequence is that it will rank in priority after those security interests which have been registered. An unregistered security interest remains enforceable against a liquidator if the company goes into liquidation - the unregistered security interest will rank ahead of unsecured creditors.

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3)?

5.1 Introduction

5.1.1 While not exclusively relevant to the “twilight” period, until liquidation the company is the appropriate claimant for any breach of the statutory duties of directors described in answer to Question 3. The company is also the appropriate applicant for relief where the claim is in respect of a breach of the general law duty of directors of companies which are insolvent, near insolvent or of doubtful solvency to exercise their powers having regard to the interests of that company’s creditors (see Section 2.7 of this paper).

5.1.2 If a company goes into liquidation, the authority and powers of the directors are at that time superseded by those of the liquidator. The liquidator is required to review the action taken by the directors and others during the twilight period and where relevant bring proceedings to obtain compensation for the benefit of creditors in respect of any loss caused to the company. Consequently, the general rule is that after liquidation only the liquidator is empowered to bring civil actions against directors and others where there has been a breach of either legal or fiduciary duties owed to the company. There are a few exceptions to this rule in respect of certain transactions for which action may be brought by creditors or others directly. These are detailed in the table below. A creditor may also have personal remedies against a director of an insolvent company – for example, in some circumstances the Courts have held directors liable under the Fair trading Act 1986 for misrepresenting to a trade creditor the company’s financial position as a result of which the creditor has continued to supply goods on credit.

5.1.3 The primary exception to this general rule is in respect of criminal proceedings brought against directors or others under the Companies legislation. These actions must be brought by the Registrar of Companies.

5.2 Criminal Proceedings

5.2.1 A liquidator of a company who considers that an offence that is material to the liquidation has been committed by the company or any director of the company under the Crimes Act 1961, the Companies Act 1993 and other company-related legislation must report this to the Registrar of Companies. The following acts are the main criminal offences under the Companies legislation relating to insolvency in respect of which the Registrar of Companies may bring an action against the directors and others involved. Those who may be liable in respect of the following offences in addition to the directors are listed in Question 3.

Offences

(a) Liability if proper accounting records not kept – section 194

(b) Carrying on business fraudulently – section 380

(c) Leaving New Zealand, concealing or removing company property or destroying, concealing or removing company records – section 273

(d) Failure to identify and deliver property to a liquidator – section 274

(e) Making false or misleading statements or omissions – section 377

(f) Fraudulently taking or applying company property for a non authorised use (or fraudulently concealing or destroying property) – section 378

(g) Destroying, mutilating, altering or falsifying any company document by making false entries – section 379

(h) Disqualification as a director – sections 382 - 386

5.3 Civil Proceedings

5.3.1 In relation to civil proceedings, after liquidation the ability to bring actions against directors and others lies primarily with the liquidator. However, in respect of certain actions which have caused loss to the company and its creditors, the law allows a wider range of persons to bring action to recover funds for the benefit of the company's creditors. Where an action for a contribution to the company's assets is successful, even if the person bringing the action is not the liquidator, generally any recoveries made will be for the benefit of all creditors of the company and will be distributed amongst the creditors in accordance with the normal rules relating to priority.

5.3.2 The table below, sets out those people who may bring an action against the directors and others after liquidation in connection with certain transactions which the company has entered into.

Activity/transaction	**Person able to bring proceedings after liquidation**
Wrongdoing (s.301)	Liquidator, a creditor or a shareholder
Insolvent trading (ss.136 & 301)	Liquidator, a creditor or a shareholder
Reckless trading (ss.135 & 301)	Liquidator, a creditor or a shareholder
Failure to keep proper accounting records (s.300)	Liquidator only
Liability to repay distributions made to shareholders (ss. 56 & 301)	Liquidator, a creditor or a shareholder

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in Questions 2, 3 and 4, what remedies are available in the domestic court?

Offence	Remedy Available
Insolvent and Reckless Trading (ss.135-136)	The Court may order a director to make such contribution to the company's assets by way of compensation as the court thinks fit. The trend of the cases is that the measure of compensation broadly equates with most of the losses (or, sometimes) debt) incurred by the company after a date on which the Court considers the company was clearly insolvent and should have stopped trading. Where more than one director is involved each director may be held to be liable for different amounts, depending on the degree of involvement and culpability of the particular director and the duration of that director's involvement (s.301).
Distributions to Shareholders when, or as a result of which, the company is insolvent (s.56)	The distributions may in certain circumstances be recovered from the shareholder. To the extent that a distribution is not able to be recovered from the shareholder (either because the shareholder has no obligation to repay it or because the shareholder has insufficient assets or for any other reason), any director who failed to take reasonable steps to ensure the correct procedures for authorising distributions were followed, or who signed the required solvency certificate when there were no reasonable grounds for believing at that time that the company would satisfy the solvency test, will be liable to the company to repay the distribution.
Failure to keep proper accounting records (ss.194 & 300)	*Civil liability* A Court may order that the director is personally responsible for all or any part of the debts and other liabilities of the company. The Court has a wide discretion and will apply similar principles to those referred to under the insolvent and reckless trading offences. *Criminal liability* A director convicted of this offence is liable to a fine not exceeding $10,000.
Wrongdoing (misappropriation, negligence, default, breach of duty or trust) (s.301)	This section provides a mechanism for Court procedures against a director when a company is in liquidation and does not create any new category of liability. The Court may order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the Court sees fit **or** to contribute such sum to the company's assets by way of compensation in respect of the negligence, default or breach of duty or trust as the Court sees fit.
Breach of duties (statutory and others) (ss.131-134; 138-141)	The director may be ordered to compensate the company for any loss or damage caused by breach of his duty, to restore to the company any property appropriated or acquired in breach of his duty and to account to the company for any benefit obtained in breach of fiduciary duty (s.301).

Offence	Remedy Available
Carrying on business fraudulently (s.380)	A director convicted of this offence is liable to imprisonment for a term up to five years or to a fine up to NZ$200,000. Automatic prohibition from being a director or in any way involved in the management of a company for five years, without leave of the Court.
Leaving New Zealand, concealing or removing company property or destroying, concealing or removing company records (s.273)	A director convicted of this offence is liable to imprisonment for a term up to two years or to a fine up to NZ$50,000.
Failure to identify and deliver property to a liquidator (s.274)	A director convicted of this offence is liable to imprisonment for a term up to two years or to a fine up to NZ$50,000.
Making false or misleading statements or omissions (s.377)	A director convicted of this offence is liable to imprisonment for a term up to five years or to a fine up to NZ$200,000. Automatic prohibition from being a director or in any way involved in the management of a company for five years, without leave of the Court.
Fraudulent use or destruction of property (s.378)	A director convicted of this offence is liable to imprisonment for a term up to five years or to a fine up to NZ$200,000. Automatic prohibition from being a director or in any way involved in the management of a company for five years, without leave of the Court.
Destroying, altering or falsifying records (s.379)	A director convicted of this offence is liable to imprisonment for a term up to five years or to a fine up to NZ$200,000. Automatic prohibition from being a director or in any way involved in the management of a company for five years, without leave of the Court.
Conduct rendering a director unfit to be a director(ss.382 – 386)	The Registrar of Companies may order disqualification in certain circumstances for a period of up to five years; The Court may order disqualification for a period up to 10 years. (This is in addition to the automatic disqualification which follows conviction for certain offences referred to above.)
Breaches of the Fair Trading Act 1986	The Court may order a director to compensate the creditor for any loss suffered as a result of conduct towards that creditor which breached the Act.
Transactions at an undervalue (s.297)	The liquidator can recover from any other party to the transaction the amount by which the value of the consideration or benefit provided by the company exceeded the value of the consideration or benefit received by the company.

Offence	Remedy Available
Transactions having preferential effect (s.292)	If a transaction is set aside as against the liquidator, the Court may order one or more of the following: (a) that any property transferred as part of the impugned transaction be restored to the company; (b) that any property which represents the application of either the proceeds of sale of the property or money originally transferred be vested in the company; (c) the release or discharge of any security given by the company; (d) a person to pay such sums as represent the value of any benefits received by him from the company as a result of the transaction; (e) that security be provided for the discharge of any obligation imposed by or arising under the order; (f) the extent to which any person affected by the setting aside of a transaction or any order made as noted above may claim as a creditor in the liquidation (s.295). An order under these provisions cannot prejudice any interest in property acquired by a person from a person other than the company for value and without notice of the circumstances under which the property was acquired from the company (s.296).
Transactions for inadequate or excessive consideration with connected parties (s.298)	The liquidator may recover from the connected party the excessive value or the undervalue, as applicable.
Securities and charges issued in favour of connected parties (s.299)	The Court can set aside the charge or security (in whole or in part). The Court may make such other orders as it thinks proper for the purpose of giving effect to an order setting aside the security. The Court cannot set aside a security which has subsequently been purchased by another person if the purchase was made in good faith and for valuable consideration, and if at the time of the purchase the purchaser was not a connected party.
Voidable charge (s.293)	The charge can be set aside in whole or in part. The setting aside of a charge or security can not prejudice the interest in property acquired by a person as a result of the exercise of a power of sale by the grantee of the charge and for valuable consideration and without knowledge of the circumstances relating to the giving of the charge, or acquired by an assignee of the charge for value and without notice (s.296).

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in Question 3) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 Extent to which directors are obliged to co-operate with an investigation into the company's affairs following its liquidation.

7.1.1 As soon as a company goes into liquidation, present and former directors of the company must give the liquidator details of the property of the company in their possession or under their control (s.274).

7.1.2 The liquidator can by notice require those persons to deliver that property to the liquidator or the liquidator's nominee, or to dispose of the property in the manner the liquidator directs (s.274).

7.1.3 The liquidator can require any person to deliver to the liquidator books, records or documents of the company in that person's possession or under that person's control. The liquidator can also require a director or former director of the company, a shareholder, an employee or former employee, and certain other persons having knowledge of the affairs of the company to do any of the following things:

(i) To meet with the liquidator at a reasonable time or times;

(ii) To give the liquidator such information about the business, accounts or affairs of the company as the liquidator requests;

(iii) To be examined on oath or affirmation by the liquidator or the liquidator's solicitor on any matter relating to the affairs of the company;

(iv) To assist in the liquidation to the best of that person's ability (s.261).

Liquidators often use these powers to require a director to attend the first meeting of creditors in the liquidation, and to obtain information to enable the liquidator to prepare a statement of affairs for the company at the commencement of the liquidation. These powers are also used to assist the liquidator in investigating the company's affairs and the actions of directors.

7.1.4 Whilst the failure by a director to comply with obligations referred to in paragraphs 7.1.1 – 7.1.3 is punishable as an offence, as a matter of practice a liquidator wishing to obtain information will rely on the examination provisions of the Act. A court can require a person to comply with a requirement of a liquidator under section 261 and may itself summon a person for examination by the Court about a company's affairs (s.266).

7.1.5 A person is not excused from answering a question in the course of being examined by the liquidator or by the Court under these provisions, on the grounds that the answer may incriminate or tend to incriminate that person. The person's answers can be used as evidence in civil actions against the person for negligence, default or breach of duty or trust. However the answers are not admissible as evidence in criminal proceedings against that person except on a charge of perjury in relation to the testimony (s.267).

7.2 Applicable human rights laws

7.2.1 Much of New Zealand's human rights laws can be found in the Human Rights Act 1993 (which deals primarily with unlawful discrimination), the Privacy Act 1993 (which promotes and protects the privacy of natural persons– in particular the use of personal information held by other parties - in accordance with international guidelines) and the New Zealand Bill of Rights Act 1990 (which affirms, protects and promotes human rights and fundamental freedoms in New Zealand).

7.2.2 New Zealand is a signatory to the *International Covenant on Civil and Political Rights 1966,* and has acceded to the Optional Protocol. New Zealand's commitment to this Covenant is affirmed and reflected in the New Zealand Bill of Rights Act 1990.

7.2.3 Liquidators, in carrying out their functions and duties and exercising their powers, must have regard to the human rights laws in the same way as anyone else carrying out functions, powers or duties must do.

7.2.4 The New Zealand Bill of Rights Act 1990 expressly states that whenever an enactment can be given a meaning that is consistent with the rights and freedoms contained in the Bill of Rights, that meaning shall be preferred to any other meaning.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in Question 3) in connection with the offences identified in Question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

Limitation Period for Criminal Proceedings

8.1.1 The general rule is that no limitation period applies to criminal proceedings unless stipulated by statute. Except as stated in paragraph 8.1.2, no limitations apply to the offences attracting criminal liability which have been identified in the answers to Questions 2 and 6.

8.1.2 Offences under section 273 (leaving New Zealand, concealing or removing company property or destroying, concealing or removing company records) and section 274 (failure to identify and deliver company property to a liquidator) are triable summarily. Informations to commence prosecution of directors (or other parties who may be liable) for these offences must be laid within 3 years after the date of the offence.

Limitation Period for Civil Actions

8.1.3 In relation to most civil liabilities identified in Question 2 and 6, the limitation period is generally 6 years from the date on which the cause of action accrued.[23]

8.1.4 In relation to breaches of the director's statutory and other duties, the limitation period is generally 6 years from the date on which the cause of action accrued.[24] No limitation period will apply if there has been a fraudulent breach of trust or to recover company property or the proceeds of company property which have been wrongfully retained by the director or received by him and converted to his own use.[25]

8.1.5 Generally speaking proceedings against a director under the Fair Trading Act 1986 (refer Section 2.12 of this paper) must be commenced within 3 years after the date on which the conduct giving rise to the proceedings occurred.[26]

8.2 Appeals

8.2.1 Appeals are available from the decisions of the lower Courts.

QUESTION 9

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9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

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[23] Section 4 Limitation Act, 1950

[24] Section 4 Limitation Act, 1950

[25] Section 21(1) Limitation Act 1950

[26] Section 43 Fair Trading Act 1986

9.1 Introduction

9.1.1 An overseas company carrying on business in New Zealand (as that expression is defined in the Act) must apply for registration in New Zealand as an overseas company within 10 working days of commencing to carry on business (s.334)

9.1.2 Directors of overseas companies carrying on business in New Zealand do not have the statutory duties which directors of companies incorporated in New Zealand have, but it is thought that the Courts will hold that those directors, at least so far as the New Zealand operations of the company are concerned, will have duties under the general law similar to the statutory duties (refer Sections 2.1, 2.2, 2.4 and 2.7 of this paper).

9.2 Liquidation of the New Zealand assets of an overseas company

9.2.1 Irrespective of whether the overseas company is registered as such in New Zealand, a creditor, director or shareholder of that company, or the company itself or the New Zealand Registrar of Companies, can apply to the High Court of New Zealand for the liquidation of that company's assets in New Zealand. The Court can order the liquidation of the New Zealand assets irrespective of whether the company has been placed in liquidation abroad, or has been dissolved or otherwise has ceased to exist as a company under the laws of any other country (s.342).

9.2.2 The liquidation of the New Zealand assets of an overseas company will be carried out in general terms in accordance with the standard liquidation regime for a New Zealand company. This means that the transactions entered into by an overseas company during the "twilight" period identified in Question 4 as being vulnerable to attack will, to the extent that those transactions took place in New Zealand or relate to the New Zealand assets of the overseas company, be vulnerable to attack under the provisions referred to in Question 4.

9.2.3 When an overseas company which has been placed in liquidation abroad has assets in New Zealand, it will usually be necessary for the foreign liquidator to seek the assistance of a New Zealand Court in taking control of the New Zealand assets. The authority of the liquidator appointed under the domestic law of the overseas company will generally be recognised in New Zealand *(Gavigan v Australasian Memory Pty Limited (In Liquidation)* (1997) 8 NZCLC 261,449).

9.2.4 Depending on the nature of the assets in question, the foreign liquidator may decide to proceed with formal liquidation in New Zealand of the New Zealand assets of the company. Generally speaking, a New Zealand Court will recognise the foreign liquidator's authority to make the liquidation application in the name of the company. In some cases, a liquidation of New Zealand assets may be unnecessary where there are no local creditors or where local creditors can be adequately safeguarded.

9.2.5 A liquidation of assets under section 342 would not preserve New Zealand assets for New Zealand creditors, as the normal pari passu rule relating to distribution to unsecured creditors should apply universally and not on a domestic basis – however it is thought that local creditors in New Zealand whose claims fall within the categories of claim which on a liquidation have priority over unsecured creditors, will retain their priority rights.

9.3 UNCITRAL Model Law on Cross-Border Insolvency

9.3.1 In February 1999 the New Zealand Law Commission recommended that New Zealand adopt the United Nations Commission on International Trade Law's Model Law on Cross Border Insolvency, with minor amendments.[27]

9.3.2 The Model Law seeks to provide uniformity of approach to the initiation of cross-border insolvency proceedings while allowing for flexibility of approach, on a case-by-case basis, to the finding of solutions. The Law Commission's recommendations have been included in draft Insolvency Law Reform legislation released by the New Zealand Government in April 2004 for comment by interested parties. However, any legislation is unlikely to come into force until a number of New Zealand's major trading partners have adopted similar provisions.

QUESTION 10

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10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in Questions 1-9?

10.1 Directors' and employees' liability insurance is available in New Zealand. Policies offer cover for "wrongful acts", typically breach of duty while acting as a director or employee. The policies are often drafted broadly enough to cover directors and employees sued for failing to exercise diligent control over management and thus failing to safeguard against losses caused by reckless decisions and by embezzlement. Cover is also available to the company itself if it pays out under an indemnity it grants to the director or employee.

10.2 In general, these policies do not specifically deny indemnity to companies or directors for liabilities arising from insolvent trading. However, on the ground of public policy, the policies do not allow for insurance against liabilities arising from directors' or employees' deliberate fraudulent acts or omissions, wilful breaches of duty or legislation and deliberate criminal acts. Arguably, in certain situations insolvent trading that involves the directors in personal liability could come within these general exclusions, so that directors are not insured.

10.3 A company may effect insurance cover for, or pay the premium for policies taken out to cover, directors and employees in respect of:

(a) Liability, other than criminal liability, for any act or omission in their capacity as a director or employee; or

(b) Costs incurred in defending or settling any claim relating to any such liability; or

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[27] New Zealand Law Commission Report No. 52 *Cross Border Insolvency*: Should New Zealand Adopt the *UNCITRAL Model Law on Cross Border Insolvency (1999)*.

(c) Costs incurred in defending any criminal proceedings brought against them in their capacity as director or employee, in which they are acquitted.

A company can only do this if expressly authorised by its constitution and with prior approval of the board of directors – the directors who vote in favour of effecting the insurance must sign a certificate stating that in their opinion the cost of effecting the insurance is fair to the company (s.162).

10.4 Directors may pay their own premiums to insure themselves against those liabilities against which the company is unable or unwilling to insure.

10.5 The company, if expressly authorised by its constitution, also has the power to indemnify a director or employee for:

(a) Costs incurred in any proceeding that relates to liability for any act or omission in their capacity as a director or employee, but only where judgment is given in their favour or in which they are acquitted, or which is discontinued;

(b) Liability to any person other than the company or a related company for any act or omission in their capacity as a director or employee, or costs incurred by them in defending or settling any claim relating to that liability whether successful or not. However, this does not apply to criminal liability or liability in respect of a breach, in the case of a director, of their duty to act in good faith in what the director believes to be the best interests of the company or, in the case of an employee, of any fiduciary duty owed to the company or related company.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 How safe is it for directors or others involved with the company's affairs to incur further credit?

11.1.1 Insolvent trading and reckless trading provisions apply to directors, (including "de facto directors", "shadow directors", and "deemed directors"[28]).

11.1.2 In incurring further credit on behalf of the company during the "twilight" period, directors tread a very fine line. A director has a statutory duty not to agree to the company incurring an obligation, unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so (s.136). This assumes that the company can also

[28] See paragraphs 3.2.1 - 3.2.12 for a full explanation of these terms. For current purposes a "de-facto" director is someone who may not have been formerly appointed as a director but who acts in the same way as a director or is held out as such. A "shadow director" is someone in accordance with whose directions or instructions the directors of the company are accustomed to act. It will thus cover the "puppet master" who, for whatever reason, does not wish to appear on the face of the record as a director of the company but who in fact "pulls the strings" and tells the directors what to do. This would also include parent companies who in effect decide what their subsidiaries do.

meet its existing obligations when they fall due. Also, a director must not agree, or cause or allow the company's business, to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors (s.135). Directors therefore must regularly monitor their company's financial health and, in particular, complete cash flow forecasts before committing the company to any obligations. The situation should not be viewed like a hypothetical immediate liquidation – the reasonable possibility of generating future revenue and the ability to raise further credit are issues to be considered in this context.

11.1.3 In *Sandell v. Porter*[29] the High Court of Australia stated that in determining solvency, courts should take into account the debtor's ability to sell assets or borrow money within a relatively short time period. The question of what time period is acceptable will depend on the circumstances of the case. In determining cash flow insolvency the Courts have also made a distinction between insolvency and a temporary lack of liquidity.[30] Similar principles apply in New Zealand.

11.2 Can an unconnected third party rely on the validity of transactions entered into with a company (in particular guarantees and securities) during the "twilight" period?

11.2.1 The risk of dealing with a company which is or may become insolvent is that the New Zealand legal system, like many others, has a vulnerability period running back from the date the insolvency process begins. In New Zealand, the main periods are two years for transactions having preferential effect, one year for transactions at an undervalue, and one year for voidable charges.

11.2.2 Generally speaking, a transaction which an unconnected third party enters into with a company during the twilight period in the ordinary course of business and for "market" value at the time will not be struck down where the company is subsequently the subject of the formal insolvency process (liquidation). For instance, if security for debt is given at the time of incurring the debt, the security cannot be challenged later, but if the security is given for an earlier debt, this can be challenged by the liquidator.

11.2.3 Payments to unconnected third parties in the ordinary course of business, where no pressure has been applied by the third party and where the third party is unaware of the insolvency of the company or any breach of duty of the directors in allowing the company to make payment, are also not vulnerable to attack. In certain situations payments outside the ordinary course of business may not be affected by a later liquidation either.

11.2.4 Full details of the types of transaction entered into by a company before the commencement of the formal insolvency process which are vulnerable to attack, and the defences available to the other party or parties to the transaction, are set out in Question 4.

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[29] (1966) 115 CLR 666.

[30] See *Hymix Concrete Pty Limited v. Garrity* (1977) 13 ALR 321 where it was held that a company's whole financial position must be considered and a temporary lack of liquidity does not necessarily mean insolvency.

APPENDIX

Summary of NEW ZEALAND insolvency procedures and commercial issues

1. Introduction – probable law reforms

1.1 In April 2004, The New Zealand Government released draft insolvency law reform legislation for comment by interested parties. The major area of reform for corporate insolvency is in the area of business rehabilitation – it is proposed to reform New Zealand's current business rehabilitation regime (see paragraphs 3.1 – 3.4 below) with a voluntary administration regime aligned as closely as possible with the Australian voluntary administration regime.

1.2 It is also proposed to amend the provisions dealing with transactions having preferential effect (see Section 4.3 of the paper) by replacing the difficult "ordinary course of business" test by a "continuing business relationship" test similar to that used in Australia. Where there has been a continuing business relationship between a creditor and the company, the liquidator will consider the series of transactions between those parties – where the net effect of the transactions overall is that the creditor is owed less at the commencement of the liquidation than at the point when the debtor company first became insolvent, a preference will have occurred.

1.3 It is also proposed to amend the defences available to a counter-party where transactions have been made at an undervalue or have had preferential effect (refer Section 4.7 of the paper). It is proposed that a Court must deny recovery to the liquidator if the counter-party "acted in good faith" and "a reasonable person in that party's position would not have suspected that the company was, or would become, insolvent". The counter-party must also have given value for the property or altered its position in the reasonably held belief that the transfer of the property to it was valid and would not be set aside.

2. Summary of existing insolvency regime in New Zealand

2.1 The insolvency regime in New Zealand is contained mainly in the following legislation:

(a) *Insolvency Act 1967* - insolvency of natural persons

(b) *Companies Act 1993* - insolvency of corporations

(c) *Receiverships Act 1993* – receivers appointed over the assets of natural persons or corporations

(d) *Corporations (Investigation and Management) Act 1989* – can be used to regulate the affairs of corporations at risk, and associated persons (including natural persons) of those corporations.

2.2 Special provisions modifying the standard insolvency regime apply in the insolvency of corporations carrying on insurance or banking business. Entities which are not corporations are subject to modified versions of the standard insolvency regime for corporations, or a different regime altogether.

2.3 The Companies Act sets out the duties and liabilities of directors. Significantly, if the company has traded whilst insolvent, directors can be personally liable for debts incurred by the company when the company had no reasonable likelihood of being able to pay those debts. In addition, taxation legislation imposes personal liability on directors in certain circumstances for some of their company's unpaid tax debts.

2.4 Directors of failed companies can also be disqualified from becoming directors for a period of time which varies according to the circumstances. A common period is 2 - 5 years.

3. Summary of insolvency procedures for corporations

Compromises with Creditors

3.1 The board of directors of a company, a receiver of all or most of the assets and undertaking of the company (see paragraph 3.6 below) or, with the leave of the Court, any creditor or shareholder of the company, if they believe that the company is insolvent (unable to pay its debts) or is likely to become insolvent, can initiate a compromise proposal with creditors of the company.

3.2 The procedures and steps required to give effect to a compromise are set out in Part XIV of the Companies Act 1993. A compromise proposal becomes binding on a company and all creditors (or if there is more than one class, on all creditors of that class) to whom notice of the proposal is given if at least 50% in number and 75% in value of creditors or the relevant class of creditors who vote approve the compromise (with or without amendment).

3.3 It is not necessary for there to be a formal administrator of the compromise scheme, although often the terms of the compromise proposal provide for the appointment of an independent administrator or manager.

3.4 The Courts are not involved except:

- at the request of the proponent or the company, to impose a short moratorium period while the proposed compromise is being considered by creditors (proceedings in relation to debts are prohibited, although this does not affect secured creditors rights to enforce their security); or

- to deal with disputes or irregularities on the application of a disaffected creditor.

Liquidation of the company

3.5 This is also known as winding up. This can be a voluntary process instigated by the shareholders or an involuntary process by Court order (almost always initiated by creditors). A liquidator is appointed whose role is to realise the assets of the company and distribute proceeds to creditors in accordance with statutory priorities. A liquidator has the right to avoid some transactions entered into before winding up.

Receivership

3.6 Secured creditors stand outside winding up, and often stand outside formal creditors compromises. The right of secured creditors to realise their security is not affected by a creditors compromise (unless they agree) or, generally speaking, on liquidation of a debtor company. A secured creditor who holds a charge over all the assets of an insolvent company can generally appoint a receiver over those assets. With certain statutory exceptions, the secured creditor has first rights over the secured assets until its debt is paid in full.

The Court also has power, separately from a secured creditor, to appoint a receiver where the Court considers it appropriate to do so. The legislation dealing with receiverships (including Court appointed receivers) is the Receiverships Act 1993.

Statutory Management

3.7 Statutory management is a legal regime that can apply to any corporation which is operating fraudulently or recklessly, or to which it is desirable that the Act should apply:

- for the purpose of preserving the interests of the corporations' members or creditors; or

- for the purpose of protecting any beneficiary under any trust administered by the corporation; or

- for any other reason in the public interest,

if those members, creditors, or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1993 or in any other lawful way.

3.8 Statutory Managers are appointed by the Government in accordance with a recommendation of the New Zealand Securities Commission which must be satisfied that certain statutory criteria are met before it makes a recommendation.

3.9 Historically statutory management has been applied to companies or groups of companies which have problems of such an extraordinary nature that the ordinary insolvency regime under the Companies Act cannot deal adequately with them (for example, because of the size, complexity, or importance of the corporations' activities).

3.10 Statutory management cuts across the rights of the corporations' creditors far more extensively than do ordinary insolvency regimes. The liquidation of the company is only one of the possible options for a statutory manager. The aim of statutory management is to freeze the position of the corporation so as to preserve the interests of members, creditors and the public, and to resolve the difficulties of the corporation. Extensive moratorium provisions apply which preclude creditors, including secured creditors, from exercising rights and powers against the corporation. The regime contains provisions allowing the statutory manager to suspend obligations and terminate certain contracts.

3.11 The statutory management regime is rarely used – it has been applied to only 8 groups of corporations since 1989.

4. Summary of commercial issues

4.1 Directors of companies in liquidation can be exposed to personal liability for insolvent or reckless trading and for breaches of duty and other defaults. Although actions for insolvent or reckless trading in theory can be taken before liquidation, in practical terms because directors are generally in control of the company up to liquidation these actions are only taken by the liquidator after the company goes into liquidation.

4.2 Relatively few actions are taken against directors for insolvent trading.

4.3 One reason why such actions are not commonplace is that they are expensive to run and can become complex, for example, because insolvency of the company at various times needs to be proved by expert evidence.

4.4 However, external litigation funding sources are becoming increasingly available to insolvency practitioners who have minimal or no funds in the administration. This can increase the threat to directors.

4.5 The Courts have generally been realistic in the retrospective review of the conduct of directors. They understand that business involves risk, and they are prepared to give directors some latitude when determining at what point in time insolvent or reckless trading began.

4.6 At the same time, the Courts have shown little tolerance for passive directors who leave the hard work to others and claim that they did not know what was happening.

4.7 There are recent examples of the Registrar of Companies (the Government body responsible for administering and enforcing the Companies Act) prosecuting high profile directors where companies have failed.

4.8 The Registrar of Companies can also take steps to disqualify directors, although this action usually takes place well after the liquidation has concluded.

4.9 Actions by liquidators to set aside voidable transactions are commonplace (in New Zealand there is no requirement to prove an intention to prefer a creditor, but the transaction must have been outside "the ordinary course of business" – a concept about which there is uncertainty and much judicial comment). These actions do not, however, universally result in a net return to creditors.

4.10 After the liquidator's remuneration and secured creditors and priority creditors (for example employees) are paid, returns to unsecured creditors are often minimal or (if the company's assets have been completely depleted) non-existent.

RUSSIA

QUESTION 1

1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Introduction

The insolvency legislation in Russia basically consists of the Civil Code of the Russian Federation (the "**Civil Code**") and three laws:

(a) *Federal Law No. 127-FZ on Insolvency (Bankruptcy)* of 26 October 2002 (the "**Insolvency Law**"), which is the principal legislation on insolvency in Russia.

(b) *Federal Law No. 40-FZ on Insolvency (Bankruptcy) of Credit Organisations* of 25 February 1999 (as amended) (the "**Bank Insolvency Law**").

(c) *Federal Law No. 122-FZ on Specifics of Insolvency (Bankruptcy) of Natural Monopolies* of 24 June 1999 (repealed by the Insolvency Law with effect from 1 January 2005).

Provisions regarding some areas of insolvency procedures and liability of officers and third parties are also included in the Criminal Code of the Russian Federation (the "**Criminal Code**"); the Administrative Offences Code of the Russian Federation (the "**Administrative Offences Code**"); the Arbitrazh Procedure Code and in Federal Law of the Russian Federation No. 208-FZ on Joint Stock Companies of 26 December 1995 (as amended) (the "**JSC Law**") and Federal Law of the Russian Federation No. 14-FZ on Limited Liability Companies of 8 February 1998 (as amended) (the "**LLC Law**").

Bankruptcy cases in Russia are heard by "arbitrazh courts" which, for ease of reference, we refer to as "bankruptcy courts". The High Arbitrazh Court (the "**HAC**"), which is the supreme arbitrazh court in Russia has issued a number of interpretations with respect to various aspects of insolvency legislation and procedure.

1.2 Brief description of insolvency procedures in Russia.

According to the Insolvency Law, insolvency proceedings consist of one or more of the following stages:

(a) supervision (*nabludenie*), a preliminary stage of insolvency proceedings intended to determine the debtor's solvency, secure its assets, draw up a register of creditors' claims and convene the first creditors' meeting;

(b) financial recovery (*finansovoe ozdorovlenie*), a stage designed to offer the debtor the chance to obtain an extension of time to meet its liabilities with the help of financial support by a third party;

(c) external management (*vneshnee upravlenie*), a stage, in which the current ownership structure of the debtor is maintained pending its efforts to regain solvency;

(d) liquidation (*konkursnoe proizvodstvo*), i.e. winding-up; and

(e) amicable settlement (*mirovoe soglashenie*), which does not, strictly speaking, constitute a separate stage of the insolvency proceedings, but rather the successful outcome of one of the other stages.

Russian bankruptcy laws focus primarily on various procedures to make the debtor solvent again. They contain very few provisions on the liability of directors and others involved in the management of the company, and very general provisions on challenges which may be brought against transactions entered into by a company which consequently becomes insolvent.

1.3 "Twilight" period

1.3.1 Determining the "twilight" period

Under Russian law the "twilight" period is deemed to begin when a company meets the insolvency criteria set out in the Insolvency Law. Such period ends with the filing of a bankruptcy petition. The "twilight period" entails certain duties of the chief executive officer of the debtor, which are discussed below.

The insolvency criteria envisaged by the Insolvency Law for legal entities consist in the (a) inability to satisfy a claim or claims in an aggregate amount of at least 100,000 Roubles (approx. US$ 3,500) (b) within three months of such claim or claims maturing.

Where a company meets these criteria:

(i) the chief executive officer (the "**CEO**") must inform the founders (shareholders/participants) of the company (or the owner in the case of unitary enterprises) that the company faces bankruptcy (meets insolvency criteria);

(ii) the founders (shareholders/participants) of the company (or the owner in case of a unitary enterprises) are required by law to take measures to return the debtor to solvency;

These two procedures are referred to as "bankruptcy prevention" measures but they essentially aim to prevent the commencement of formal bankruptcy proceedings.

1.3.2 Duty of the CEO to inform the shareholders/participants

Although such a duty is envisaged by the Insolvency Law, there are no provisions relating to the liability of the CEO for failing to inform the shareholders/participants of the company that it meets the insolvency criteria. The means of communication are not established and it is unclear how this duty must be discharged in the event the company has a large number of shareholders/participants.

1.3.3 Duty of the founders (shareholders/participants)

If the company encounters financial problems the founders (shareholders/participants) of the company are to take measures to make the debtor solvent again. The Insolvency Law does not specify which measures need to be undertaken and does not impose any liability for failure to act. However, the Insolvency Law provides that these measures can be undertaken by the creditors or third parties with the debtor's consent.

The only measure expressly envisaged by the Insolvency Law is rehabilitation prior to court proceedings (*dosudebnaya sanatsiya*). Rehabilitation is financial assistance to the debtor in an amount sufficient to satisfy monetary obligations, to make mandatory payments (i.e. taxes) and to restore the debtor's solvency. In the event financial assistance is provided, the debtor or other persons may assume obligations for the benefit of the persons providing such financial assistance.

1.4 Duty to file a bankruptcy petition

The Insolvency Law provides for the obligation of the CEO of the debtor (who may also be a member of the board of directors) to file a debtor's bankruptcy petition in the following instances:

(a) the settlement of claims of one creditor or several creditors renders it impossible for the debtor to discharge monetary obligations or to perform the duty of making mandatory payments and/or other payments in full to other creditors;

(b) the debtor's body authorised in accordance with the debtor's foundation documents to make the decision to liquidate the debtor has adopted a decision to file a debtor's petition with a bankruptcy court;

(c) the body authorised by the owner of property of a debtor that is a unitary (i.e. government-owned) enterprise has decided to file a debtor's petition with a bankruptcy court;

(d) levy of execution on the debtor's property will significantly aggravate or render impossible the debtor's economic activity;

(e) in other cases specified by the Insolvency Law.

The debtor's bankruptcy petition is to be filed within one month from the date the aforementioned facts occur. It must be filed with a bankruptcy court in writing and must be signed by the chief executive officer (director) of the debtor or by a person authorised under the debtor's foundation documents to file petitions requesting that the debtor be declared bankrupt.

The following information is to be indicated in the debtor's petition:

(1) the name of the bankruptcy court with which the petition is being filed;

(2) the sum of creditors' claims arising from monetary obligations not disputed by the debtor;

(3) the sum of debts owed as compensation for harm to citizens' life and health, as wages/salaries and severance benefits payable to the debtor's employees, and the sum of royalties payable under copyright agreements;

(4) the sum of debts relating to mandatory payments;

(5) an explanation of the inability to meet the creditors' claims in full or of significant aggravation of economic condition in the event of levy of execution;

(6) details of claims against the debtor, writs of execution and other documents filed for the purpose of direct debiting of funds from the debtor's accounts and accepted by courts of general jurisdiction, bankruptcy courts and arbitral tribunals;

(7) details of the property owned by the debtor, including amounts of money and accounts receivable;

(8) the numbers of the debtor's accounts in banks and other credit organisations and the addresses of the banks and other credit organisations;

(9) the name and address of the self-regulating organisation from among whose members the bankruptcy court is to approve an interim administrator;

(10) the amount of remuneration payable to the court-appointed administrator;

(11) a list of the documents attached.

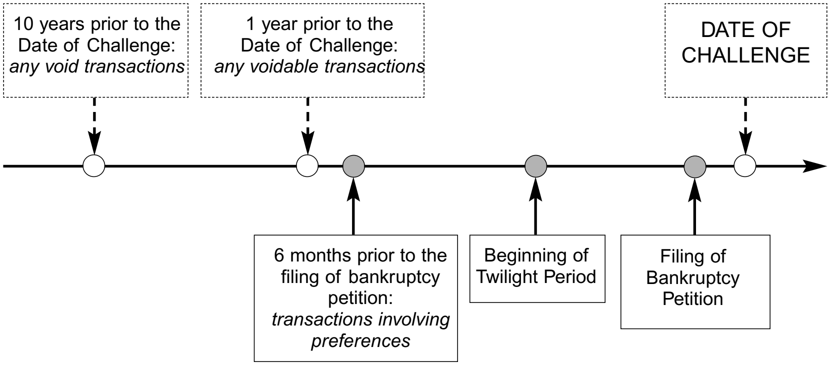
Failure to file the petition results in subsidiary liability of persons in whom the duty is vested to make the decision to file for bankruptcy or immediately file for bankruptcy. Such subsidiary liability covers the debtor's liabilities that have occurred after the expiration of the aforementioned one-month period.

In addition to the debtor, the bankruptcy petition can be filed by an insolvency creditor (*konkursniy kreditor*) and certain authorised federal government agencies. Before a creditor can commence insolvency proceedings, it must (1) obtain a court judgment against the debtor in an amount satisfying the relevant insolvency criteria and (2) demonstrate that it has sought and failed to achieve execution of that judgment for a period of 30 days after the date of such judgment. In the case of a bankruptcy petition by an authorised government agency, the 30-day period runs from the date on which the relevant authority adopted the decision to seize the debtor's assets to satisfy the obligations owed to the government.

1.5 Challenging Transactions in Bankruptcy

According to Russian law, transactions entered into by the debtor (i.e. insolvent entity) prior to the commencement of insolvency proceedings may be challenged on various grounds (see 4 below). It should be noted that certain preferential transactions may be challenged even if they were entered into before the "twilight period".

This may be illustrated by the following diagram:



QUESTION 2

2. Actions potentially giving rise to liability for directors[1]

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(ii) will liability attach to individual directors in proportion to their specific involvement?;

[1] Please highlight any relevant distinctions between executive and non-executive directors and the different responsibilities, if any, of members of different boards of a company if applicable (e.g. members of the executive board and members of a supervisory board).

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(iv) what defences, if any, will be available in relation to each offence?

2.1 Overview

Russian law does not distinguish between executive and non-executive directors when providing for their obligations or liabilities. All members of the board of directors (supervisory board)[1] are elected by the general shareholders' meeting, have the same responsibilities and are subject to the same scope of liability. The members of the board of directors elect the chairman of the board of directors by a majority vote. However, as a matter of Russian law the chairman of the board of directors is not subject to a higher level of liability than the other members of the board of directors.

The JSC Law introduced a concept of "independent" director for the purposes of approval of "interested party" transactions[2] in a company with more than 1000 shareholders. No additional responsibilities are envisaged for "independent" directors.

As a matter of Russian law the management board is a collegiate executive body of the company responsible for the day-to-day activities of the company. Members of the executive board may also serve on the board of directors. However, they may not comprise more than 25% of the board of directors. Russian law does not provide for any special or additional liability of members of the management board, regardless of whether they also serve on the board of directors.

2.2 Civil liability of members of the board of directors.

2.2.1 General principles

A person who represents the entity by virtue of law or foundation documents must act in good faith and reasonably in the best interests of the company. Unless otherwise provided by the law or by specific agreement directors have an obligation to compensate the losses caused by them to the legal entity[3].

Members of a company's board of directors are jointly and severally liable to the company for damages incurred by the company due to their improper actions or inaction for which they are at fault (with the exception of those members of the board of directors who voted against the resolution that caused damages to the company)[4].

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[2] An "interested party" transaction is a transaction in the performance of which there is an interest of a member of the board of directors, the chief executive officer, a member of the management board or a shareholder which owns jointly with its affiliates 20 and more per cent. of the voting shares in the company, as well as a person who has authority to issue instructions mandatory for the company. Under Russian law "interested party" transactions are subject to special corporate approvals.

[3] Article 53 of the Civil Code

[4] Article 71 of the JSC Law and Article 44 of the LLC Law

For a member of the board of directors to be liable, damages must be incurred by the company as a result of the board member's failure to comply, due to his fault, with the requirement that he should act reasonably and in good faith when exercising his rights and fulfilling his obligations.

A person is deemed to be at fault if under that degree of care and circumspection which was required of him according to the nature of the obligation and the conditions of commerce, he did not take all possible measures for proper performance of the obligation[5]. The damages are to be compensated in full, including loss of profit.

At the same time, Russian law does not provide for direct liability against directors for undervalue transactions and preferences. However, certain transactions entailing preferences may be challenged (see 4.3.2 below).

2.2.2 Liability for insolvency (bankruptcy) of a company.

(a) *The Civil Code provisions*

The Civil Code[6] provides that, in the event of the bankruptcy of a company, which is occasioned by "persons who have the right to give instructions binding on such company" or by persons who "otherwise have the possibility to determine the actions of the company", such persons may bear subsidiary liability for the obligations of that company in the event it has insufficient property.

While the principal focus of Article 56 of the Civil Code is on the founders, shareholders and principal (controlling) company of the insolvent company, the actions of members of the board of directors may also fall within such definition.

(b) *The LLC Law provisions*

The LLC Law contains provisions very similar to those of the Civil Code. If the bankruptcy of a company is occasioned by its participants or other persons who have the right to give instructions binding on such company or otherwise determine the actions of the company such persons may bear subsidiary liability for the obligations of that company[7].

(c) *The JSC Law provisions*

In contrast with the above laws, the JSC Law contains provisions that appear to restrict considerably the scope of potential liability borne by members of the board of directors of joint stock companies. The JSC Law imposes a restricted standard of potential liability to those situations where such members "*have used their controlling right with the purpose of the company's taking an action knowing in advance that such action would entail the company's insolvency (bankruptcy)*"[8]. As a matter of constitutional law, in the event of inconsistency between the JSC Law and the Civil Code the latter should prevail, and the interaction of the relevant provisions of the Civil Code

[5] Article 401 of the Civil Code
[6] Article 56 of the Civil Code
[7] Article 3 of the LLC Law
[8] Article 3 of the JSC Law

and the JSC Law could be the subject of dispute in the event of legal action with respect to their applicability.

2.3 General criminal liability of members of the board of directors.

2.3.1 General principles

It should be noted that the provisions relating to criminal liability do not refer specifically to members of the board of directors. Given that violations prohibited by criminal legislation are most likely to occur in the context of day-to-day management of the company, the general director of the company (who is, by definition, the chief executive officer of the company) is the person most likely to incur liability.

Nevertheless, an ordinary member of the board of directors could also be subject to criminal liability as an individual performing management functions in a company. For example, this can occur if a member of the board of directors directly and knowingly decides on or takes any action which is prohibited under the applicable criminal legislation.

Below is a summary of the main provisions of Russian criminal law applicable to members of the board of directors of a company. These provisions apply during the “twilight” period as well.

2.3.2 General criminal liability applicable to members of the board of directors of a company

The Criminal Code[9] provides, *inter alia*, that a person performing management functions in a company who uses his position in violation of the law and counter to the interests of the company and causes damage to the company faces liability ranging from a fine to imprisonment. If the actions of such person damaged only the interests of the company (and the company is not a state or municipal enterprise), only the company may initiate prosecution of the person.

2.3.3 Criminal and administrative liability for money-laundering or other legalisation of unlawfully obtained property

The performance of financial operations and transactions with unlawfully obtained money and other property (money-laundering) may be punishable by a fine or imprisonment. The same actions involving large amounts are punishable by imprisonment together with possible confiscation of personal property[10]. A member of the board of directors of a company may be subject to this liability if he is guilty of such activities.

2.3.4 Criminal liability for illegally obtaining and disclosing commercial, tax or banking secrets

The Criminal Code[11] provides for criminal liability for illegal collection, disclosure or use of commercial, tax or banking secrets without the consent of the owner of such secrets by a person who is informed of such secrets or

[9] Article 201 of the Criminal Code
[10] Articles 174 and 174.1 of the Criminal Code
[11] Article 183 of the Criminal Code

who becomes aware of such secrets due to his position or work. A member of the board of directors may qualify for criminal liability under this article. The punishment includes, *inter alia*, a fine and imprisonment.

2.3.5 Criminal liability for illegal gains

A director performing management functions in a company (i.e. a director who is also a company's executive) may be subject to criminal liability for illegal receipt of money, securities, other assets or illegal use of services from third parties with the aim of performing actions (inaction) in favour of such third parties in connection with the person's position in performing management functions at the company[12].

2.3.6 Criminal liability for unlawful business activity

A member of the board of directors of a company may be held liable under if due to his fault the company engages in entrepreneurial activity without a licence or registration or in violation of the registration or licensing requirements[13]. Sanctions may include a fine, community service or imprisonment.

2.4 General administrative liability of members of the board of directors

2.4.1 Administrative liability for money-laundering

There is administrative liability for violation of the money-laundering legislation, in particular, for violation of the rules on recording, storage and disclosure of information about operations which are subject to mandatory control and the rules on internal control in a company[14]. A member of the board of directors may qualify for administrative liability under this article.

2.4.2 Administrative liability for business activity without a license or registration

A member of the board of directors of a company may be held liable if the company engages in entrepreneurial activity without a licence or registration or in violation of the registration or licensing requirements[15]. The basic sanction for this offence is an administrative fine.

2.5 Criminal and administrative liability for illegal actions during the bankruptcy

2.5.1 Criminal liability for illegal actions during bankruptcy

The Criminal Code contains three *corpus delicti* directly related to insolvency:

(a) unlawful actions taken in case of insolvency[16] which caused severe damage, i.e. concealing property or property obligations, withholding information on property, its size, location or any other information; transferring of property to other persons, alienating or destroying property; and concealing, destroying or falsifying accounting documents.

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[12] Article 204 of the Criminal Code
[13] Article 171 of the Criminal Code
[14] Article 15.27 of the Administrative Offences Code
[15] Article 14.1 of the Administrative Offences Code
[16] Article 195 of the Criminal Code

(b) deliberate bankruptcy[17], i.e. wilfully causing or contributing to insolvency if such actions caused severe damage.

(c) fraudulent bankruptcy[18] intended to deceive creditors in order to obtain either a deferral or extension of payments owed to creditors, or a discount of debts or non-payment of debts if such has caused damage.

The Criminal Code provides for liability for the above-mentioned actions during bankruptcy and in anticipation of bankruptcy. Therefore, if committed during the “twilight” period such actions give rise to the liability of the chief executive officer or owner of a company. The provisions of the Criminal Code are likely to apply to members of the board of directors as well.

2.5.2 Administrative liability for illegal actions during bankruptcy

The Administrative Offences Code also contains provisions with respect to insolvency[19]. These include the following offences:

(a) fraudulent insolvency, i.e. knowingly fraudulent declaration of bankruptcy by the chief executive officer of a legal entity;

(b) deliberate bankruptcy, i.e. wilfully causing or *contributing to* insolvency;

(c) unlawful actions taken in case of insolvency, i.e. concealing property or property obligations, withholding information on property, its size, location or any other information; transferring of property to other persons, alienating or destroying property; and concealing, destroying or falsifying accounting documents;

(d) failure to file a debtor’s bankruptcy petition;

(e) non-compliance with the requirements applicable during supervision and external administration, entering into and execution of amicable settlements and other bankruptcy procedures.

The Administrative Offences Code introduces liability for failure to file a debtor’s bankruptcy petition in the cases envisaged by the law. This is a blanket provision that refers to the Insolvency Law (see 1.2). Liability for this offence can take the form of an administrative fine or disqualification.

2.5.3 Summary

Although the content of administrative and criminal wrong-doings is very similar they should be differentiated. The essential distinction consists in the damage caused by a wrong-doing. The Administrative Offences Code does not specify the amount or scope of the damages caused by the offence, while the Criminal Code provides that illegal actions during bankruptcy which caused *severe* damage may result in criminal liability. The degree of damage is, therefore, the main distinctive criterion.

[17] Article 196 of the Criminal Code
[18] Article 197 of the Criminal Code
[19] Articles 14.12 and 14.13 of the Administrative Offences Code

With respect to fraudulent bankruptcy, the Criminal Code specifies the motives of the liable person and consequences of his/her actions as factors relevant for the purposes of determining whether criminal liability attaches. The Administrative Offences Code does not specify these criteria but rather provides an example of what may constitute fraudulent bankruptcy within the scope of administrative law, i.e. filing a bankruptcy petition notwithstanding the fact that the debtor has sufficient funds to satisfy creditors' claims.

In the case of deliberate bankruptcy the provisions of the Criminal Code and the Administrative Offences Code also differ. The latter does not specify which individuals may incur liability, and therefore members of the board of directors may also be held liable if they wilfully create or contribute to insolvency. Article 14.12 of the Administrative Offences Code (*Fraudulent or deliberate bankruptcy*) implies that there must be direct intent in committing deliberate bankruptcy.

2.6 Defences

2.6.1 Defences in civil proceedings

Under the JSC Law and the LLC Law members of the board of directors are to act in the interests of the company, exercise their rights and carry out their duties reasonably and in good faith. According to Russian legal doctrine, acting in good faith means acting without intent to cause damages to another person and without negligence with respect to potential damage that can be done. Reasonable actions imply actions of a person with normal levels of judgment and intelligence in a specific situation.

Members of the board of directors acting within a reasonable level of commercial risk for the benefit of the company are not likely to be held liable for damages caused to the company by their actions during the "twilight" period.

2.6.2 Defences in criminal proceedings

Russian criminal law does not provide for special defences related to bankruptcy proceedings and potential claims to the directors. However, the Criminal Code specifies a list of general defences (circumstances in which criminal liability may not be imposed). They include, *inter alia,*

(a) Extreme necessity, where legally protected interests are harmed in order to remove a specific danger to the acting person or his/her rights, rights of other individuals or to protect the general public;

(b) Duress;

(c) Justified risk, i.e. harming legally protected interests provided this risk is justified by attaining otherwise socially useful goals;

(d) Insanity.

These are the general provisions but they are unlikely to apply to crimes in relation to bankruptcy.

2.6.3 Defences in administrative proceedings

The Administrative Offences Code provides that administrative liability may not be imposed under the following circumstances:

(a) Extreme necessity, where legally protected interests are harmed in order to remove a specific danger to the acting person or his/her rights, rights of other individuals or to protect the general public; and

(b) Insanity;

When an offence is insignificant the body responsible for resolving the case relating to the offence has discretion to “relieve” the person of the administrative liability. As in the case of criminal liability, this is unlikely to apply to offences relating to bankruptcy.

QUESTION 3

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3. Other persons involved with the company’s affairs who may become liable in respect of their actions during the “twilight” period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company’s activities during the “twilight” period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

3.1 Overview

Under Russian law there are three categories of persons which may be held liable for the debts of an insolvent entity:

(a) Persons required to file for bankruptcy (e.g. CEO);

(b) Controlling Persons; and

(c) Parent Company.

3.2 Liability of persons required to file for bankruptcy

The law makes it compulsory for the following persons to file for bankruptcy in circumstances set out below:

(1) The CEO of the debtor (or any other person acting in the name of the debtor without a power of attorney) if satisfaction of claims of one or more creditors leaves the debtor unable to satisfy its monetary obligations arising under civil law grounds to other creditors in full, or the relevant body of the debtor has decided to file for bankruptcy;

(2) The CEO of the debtor (or any other person acting in the name of the debtor without a power of attorney) and members of the liquidation commission of the debtor if, after the decision to liquidate the debtor has been made, the debtor is not able to satisfy the claims of its creditors in full;

(3) The chairman of the liquidation commission (liquidator) if the value of the debtor's assets are insufficient to satisfy the claims of its creditors in full; and

(4) The CEO of the debtor (or any other person acting in the name of the debtor without a power of attorney), founder (participant) and owner of the assets of a unitary enterprise debtor, if the decision to liquidate the debtor has been taken, the liquidation commission has not yet been established, and the value of the debtor's assets are insufficient to satisfy in full the claims of its creditors.

The persons mentioned in (1) and (2) above must file for bankruptcy within one month of the relevant circumstances arising; if they fail to do so, they will be secondarily liable for *new debts* arising after the date when the petition for bankruptcy should have been filed, as well as potential additional liability.

No time period is specified for filing under (3) and (4) above; however, should these persons fail to file, they will be secondarily liable for *all unsatisfied* financial obligations (i.e. (i) monetary obligations based on civil law, and (ii) the obligation to pay taxes and other mandatory payments to various budget or extra-budgetary funds of the debtor.

3.3 Liability of Controlling Persons

Under Russian law a person who has the right to give mandatory instructions or otherwise determine the activities of a company (a "**Controlling Person**") may in certain circumstances be liable for the debts of the company controlled by such person. Controlling Persons include founders (shareholders/participants), shareholders who are members of the management board or board of directors and the CEO.

As a general rule, if bankruptcy (insolvency) of the legal entity was caused due to the fault of a Controlling Person of the company, the assets of which are insufficient to pay its debts, such person may be secondarily liable for the obligations of such legal entity. The same provision is envisaged by the LLC Law.

A Controlling Person may be secondarily liable for the obligations of a joint stock company with assets insufficient to pay its debts if the bankruptcy of such company was caused by the acts or failure to act of the Controlling Person, who gave obligatory instructions or who determined the course of action of such company knowing that the consequence of this action would be the insolvency of the company[20].

While similar to the provisions of the Civil Code and the LLC Law above, this provision of the JSC Law differs in that it requires not only the use by the Controlling Person of his rights or powers, but also actual knowledge by the Controlling Person that his actions or failure to act will cause the bankruptcy of the company.

3.4 Liability of the Parent company.

Under Russian law[21] a company/partnership having the possibility to determine the course of activities of another company (the "**subsidiary"**) is considered to be a parent company ("**parent company**"**)** of such subsidiary. The possibility may be a result of the parent company's shareholding in the subsidiary, a provision in the charter of the subsidiary or an agreement entered into between the parent company and its subsidiary. If the bankruptcy (insolvency) of the subsidiary was caused by the parent company, the latter becomes secondarily liable for the debts of the subsidiary.

Outside of bankruptcy, a parent company with the right to give mandatory instructions to its subsidiary may be held jointly and severally liable for obligations incurred by the subsidiary as a result of such mandatory instructions, irrespective of whether any damages were caused to the subsidiary or any fault of the parent company[22]. If a parent company is responsible, the shareholders of the subsidiary may demand that the parent company compensate such damages, unless otherwise provided by law[23].

The Civil Code does not define causation or the degree of fault sufficient to trigger the above rules. The inquiry is likely to be very fact-specific in each case.

The JSC Law and the LLC Law treat parent's liability upon its subsidiary's insolvency somewhat differently. According to the LLC Law, If the bankruptcy of a subsidiary is caused by the parent, the latter becomes secondarily liable for the debts of the subsidiary if its assets are insufficient to pay its debts[24]. On the other hand, the JSC Law provides that if the bankruptcy has been caused by the parent, the latter becomes secondarily liable for the subsidiary's debts only if the parent used its rights (set out in the charter of the subsidiary or in the agreement with the subsidiary) or its right to give mandatory instructions to the subsidiary deliberately knowing that its instructions will result in the insolvency of the subsidiary[25]. This provision is narrower than those discussed above as its application is limited to situations where the parent company has actual knowledge that insolvency of the subsidiary would follow.

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20 Article 3, clause 3 of the JSC Law
21 Article 105 of the Civil Code
22 Article 105 of the Civil Code
23 Article 105, clause 3 of the Civil Code
24 Article 6 of the LLC Law
25 Article 6, clause 3 of the JSC Law

QUESTION 4

4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Overview

Russian law provides for a number of grounds on which transactions entered into by an entity facing insolvency may be challenged. However, Russian insolvency law contains provisions that allow invalidation of a debtor's transactions concluded not only during the "twilight" period (see Section 1), but before this period commences.

Under the Insolvency Law an insolvency manager can challenge certain transactions and decisions of the debtor at every stage of insolvency proceedings. However, special provisions of the Insolvency Law[26] entitle the insolvency manager at the stages of external management and liquidation to challenge any transaction entered into by the debtor both before and after commencement of insolvency proceedings. Since no limitation periods are envisaged with respect to these powers of the insolvency manager the general principles of the Civil Code apply[27].

4.2 General principles in respect of void and voidable transactions

Under Russian law there are two types of transactions that can be held null and void. A null and void transaction is null *ab initio* irrespective of whether it is recognised as such by the court. To hold a voidable transaction invalid a judgment of the court is required.

The Civil Code provides that, as a general rule, transactions inconsistent with the law, entered into contrary to public policy etc, are null and void. Other transactions are voidable. They include, *inter alia,* transactions of legal entities made *ultra vires*, fraudulent transactions, transactions entered into under duress etc.

The limitation period for null and void transactions is ten years from the commencement of the transaction. If the claim is filed seeking a declaration of an invalid transaction (i.e. the transaction is voidable), a one-year limitation period would apply, starting from the date on which the party learned or should have learned of the circumstances serving as grounds for invalidation

[26] Articles 103 and 129 of the Insolvency Law
[27] Article 181 of the Civil Code

of the transaction. As the Insolvency Law does not provide for limitation periods, the general provisions of the Civil Code apply.

4.3 Declaring Transactions Invalid under the Insolvency Law

4.3.1 Transactions entered into with "interested parties"

A court may invalidate a transaction concluded by an insolvent debtor with a so-called "interested party" if, as a result of the performance of such transaction, the creditors of the insolvent debtor or the insolvent debtor itself suffered or may suffer losses[28].

An "interested party" is defined as a company which is a holding or subsidiary company of the insolvent debtor, any members of the board of directors, executive body or the chief accountant of the insolvent debtor. The time of entering into such transactions is irrelevant for these purposes, and therefore this clause can apply to transactions entered into outside the "twilight" period.

If obligations under a transaction described in the previous paragraph have already been performed and the insolvent debtor or its creditors have already suffered losses a claim can be brought: (1) to declare a transaction null and void, and (2) to apply the legal consequences of nullity of a voidable transaction. In the event such action is successful, this is likely to result in reciprocal restitution and recovery of damages from the "interested party".

4.3.2 Transactions entailing preferences

Article 103.3 of the Insolvency Law further provides that a court may invalidate transactions concluded after the filing of a petition to declare a debtor insolvent or up to *six months* prior to such filing if, in either case, the transactions in question entail preferential satisfaction of the claims of one or more creditors over those of other creditors.

4.3.3 Exit from the company

A transaction by a debtor that is a legal entity concluded up to six months prior to the filing of a bankruptcy petition and involving payment to one of its shareholders in connection with its exit from the company may be declared invalid by a court upon demand from the insolvency manager or a creditor if the performance of such transaction infringes the rights and legal interests of creditors[29]. In the event that the debtor is declared bankrupt and insolvency management is instituted such founder (participant) of the debtor is deemed a creditor ranking in the last order of priority.

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[28] Article 103, clause 2 of the Insolvency Law
[29] Article 103, clause 4 of the Insolvency Law

QUESTION 5

5. Enforcement

By whom may action be brought against directors (and/or others identified in question 3 above)?

The company itself and any of its shareholders owning a total of at least one per cent of the company's common shares can file a claim against a member of the board of directors[30]. When a claim seeking compensation of damages is filed against a member of the board of directors of a company, the burden of proof lies with the plaintiff. This applies to claims against the CEO, directors, members of the management board and managing organisation in case damages are caused by their actions.

The right to initiate administrative proceedings relating to bankruptcy vests in the Ministry of Internal Affairs and, in certain circumstances, in other authorised official bodies.

If a person uses his position in violation of the law and contrary to the interests of the company and his actions resulted in damages only to the company (and the company is not a state or municipal enterprise), only such company may initiate prosecution of the liable individual[31].

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 Invalidation of transaction and restitution.

The Insolvency Law provides that a court may declare transactions invalid if they were entered into up to *six months* prior to the filing of an insolvency petition. Invalidation of a transaction implies elimination of the consequences of the transaction and, *inter alia*, can take the form of reciprocal restitution, and if restitution in kind is impossible, reimbursement of consideration in monetary form. Additionally, the court may award compensation of damages and payment of interest for use of funds by the other party.

30 Article 71, clause 4 of the JSC Law
31 Article 201 of the Criminal Code

6.2 Administrative fine and disqualification.

The Administrative Offences Code envisages the following measures of administrative liability for offences relating to insolvency (bankruptcy):

(1) fraudulent bankruptcy - administrative fine of 40-50 times the statutory minimum monthly wage[32] (the "**MMW**")[33] or disqualification for up to 3 years;

(2) deliberate bankruptcy - administrative fine of 40-50 times the MMW or disqualification for 1-3 years;

(3) illegal actions taken relating to insolvency - administrative fine of 40-50 times the MMW or disqualification for up to 3 years;

(4) failure to file a bankruptcy petition - administrative fine of 40-50 times the MMW or disqualification for up to 3 years;

Disqualification entails depriving an individual of the right to occupy any management position in the executive body of a legal entity, to sit on the board of directors (supervisory board), and to engage in entrepreneurial activity involving management of a legal entity. This punishment may last from six months to three years. Information on all disqualified persons is entered in a special register. Legal entities are under an obligation, before offering a contract for a management position, to verify with the body responsible for keeping the register that the candidate has not been disqualified.

6.3 Imprisonment and fine.

The Criminal Code envisages the following remedies:

(1) illegal actions taken relating to insolvency - imprisonment for up to 3 years; detention for 4-6 months; or imprisonment for up to 2 years plus a fine of up to 200,000 RUR.

(2) deliberate bankruptcy - either a fine of 500-800 times the MMW or imprisonment for up to 6 years and fine of up to 100 times the MMW.

(3) fraudulent bankruptcy - either a fine of 100,000 - 300,000 RUR or imprisonment for up to 6 years and fine of up to 80,000 RUR.

[32] Administrative fines in Russia are calculated in multiples of the statutory minimum monthly wage.
[33] Currently set at 100 RUR (approx. US$ 3)

QUESTION 7

7. Duty to co-operate

To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

The Insolvency Law does not impose a general duty to disclose information to insolvency managers appointed at various stages of insolvency proceedings. However, there are several provisions that entitle the insolvency manager to obtain information in respect of its business activities from the debtor. An insolvency manager is entitled to obtain any information and documents concerning the debtor's activity and the debtor's management bodies are to provide the insolvency manager upon his request with all information concerning the debtor's activity.

For example, at the stages of supervision and financial recovery, the appointment of an insolvency manager does not constitute grounds for removal of the director of the debtor or of members of other management bodies of the debtor from office. They continue to exercise their powers subject to the limitations established by the Insolvency Law. Their duty to co-operate with insolvency manager may be inferred from a number of provisions of the Insolvency Law. At the stages of external management and liquidation, the insolvency manager replaces all other governing bodies of the debtor. The issue of co-operation becomes to a considerable extent obsolete.

The requirement to provide the insolvency manager with all necessary information and documents applies to confidential information as well, since the Insolvency Law requires that the court-appointed administrator ensure non-disclosure of information protected under federal law (including information classified as an official secret or commercial secret), such information having come to his knowledge in connection with his performance of the duties of a court-appointed administrator. When implementing bankruptcy procedures the insolvency manager must act in good faith, reasonably, and in the interests of the debtor, the creditors and the general public.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Civil actions

The general limitation period under Russian civil law is three years. It starts running from the time when a party learned or should have learned of the breach of its right. Though it is not always possible to determine when a party should have learned of the breach of its right it is possible that the limitation period does not start running before the commencement of insolvency proceedings.

8.2 Administrative Offences

The Administrative Offences Code contemplates a two-month limitation period for administrative offences. This period starts running from the date an offence was committed. Where the remedy for an administrative offence is disqualification, a one-year limitation period applies.

Under the Administrative Offences Code decisions rendered with respect to administrative offences can be appealed within 10 days after they were issued or a copy of the relevant decision has been received by the defendant. An appeal may be submitted to the judge, official body or office-holder which issued the decision. Within 3 days these persons are required to submit the appeal motion to the competent court, higher official body or higher office-holder[34]. Alternatively, the appeal may be submitted directly to the authorised person or body.

8.3 Criminal Offences

The Criminal Code envisages the following limitation periods[34]:

(1) two years after the commission of a crime of small gravity;

(2) six years after the commission of a crime of average gravity;

(3) ten years after the commission of a crime of a grave crime;

(4) fifteen years after the commission of an especially grave crime.

[34] Article 30.2 of the Administrative Offences Code.
[35] Article 78 of the Criminal Code.

Under Russian criminal law illegal actions relating to bankruptcy are considered crimes of “small” gravity; therefore the limitation period in respect of them is two years. Deliberate bankruptcy and fraudulent bankruptcy are “grave” crimes, and the limitation period for them is 10 years.

As a general rule, limitation periods are calculated from the day the crime is committed.

QUESTION 9

9. Foreign corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations and companies?

The Insolvency Law applies to all legal entities with the exception of state enterprises, institutions, political parties and religious organisations. It also states that the relations involving foreign persons as creditors are subject to the provisions of the Insolvency Law, except as otherwise envisaged by international treaty to which the Russian Federation is a party. Although the Insolvency Law does not contain any provisions expressly stating that it does not apply to insolvent foreign entities, as a practical matter application of the procedures outlined above to foreign entities could be problematic, and Russian bankruptcy courts may decline to assert their jurisdiction over such entities in bankruptcy matters.

QUESTION 10

10. Insurance

Is directors’ and officers’ insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

The law establishes liability of members of the board of directors (supervisory board) for damages[36]. Therefore, they incur a legal liability risk that can be insured.

An insurance contract can be concluded by the company itself or by an individual who is the CEO, member of the board of directors or member of the management board of the company.

[36] Article 71 of the JSC Law and Article 44 of the LLC Law

The following risks relating to insolvency may be insured:

(1) any violation of management duties, negligence, failure to act, error or director's misrepresentation or inaccurate statements;

(2) any actions of the director in the course of performance of his official duties;

(3) violation of conditions relating to the powers of directors envisaged by the law.

Insurance policy may provide for the following indemnities:

(a) indemnity of damages awarded pursuant to a court decision;

(b) indemnity of damages agreed in an out-of-court settlement;

(c) necessary and reasonable expenses to conduct the defence.

Losses caused to a company by a member of the board of directors are reimbursed by an insurance company within the limits specified in the insurance contract. If the insurance indemnity is insufficient to cover reimbursement of all losses caused to a company, the responsible member of the board of directors will have an obligation to reimburse the difference between the insurance indemnity and the de facto amount of the losses that were suffered[37].

Insurance programs on insurance of the liability risk of management bodies of commercial entities are offered in Russia by a number of insurance companies, although the practice is not yet widespread.

QUESTION 11

11. Incurring further credit and counter-party risks in dealing with a company during the twilight period

Two key issues continually arise when considering the question of the duties of directors and others during the twilight period. First, how safe is it for directors or others involved with the company's affairs to incur further credit and secondly, can an unconnected third party rely on the validity of transactions entered into with a company (in particular guarantees and security) in each case during the twilight period?

Russian bankruptcy laws do not contain any provisions with respect to incurring further credit by an insolvent company. Unconnected third party may rely on the validity of transactions entered into with an insolvent company subject to the general provisions discussed above.

[37] Article 1071 of the Civil Code

SPAIN

OVERVIEW

On 9 July 2003, the Spanish central parliament approved a new insolvency act (the ***Insolvency Act***), which came into force on 1 September 2004 and applies to any insolvency proceedings initiated in Spain after that date. The Insolvency Act replaces the previously archaic and fragmented regulation[1] with a single consolidated insolvency law. Insolvency proceedings pending at the time the Insolvency Act became effective are still administered in accordance with the old insolvency legislation, subject to certain modifications. The Insolvency Act:

(a) establishes a single insolvency procedure (*concurso*) pursuant to which a company may be declared insolvent if it cannot meet its payment obligations. This single procedure replaces the two corporate insolvency proceedings under the old insolvency legislation, namely:

   (i) suspension of payments (*suspension de pagos*): based on the concept of provisional insolvency (i.e. where a company's assets exceed its liabilities but the company anticipates liquidity problems in meeting its debts as they fall due). The aim of the suspension of payments proceedings was to achieve a binding settlement with creditors (enforceable on all, except secured creditors), as to when and to what extent creditors would receive payments; and

   (ii) bankruptcy (*quiebra*): based on definitive insolvency (i.e. when the company's liabilities exceed its assets). The company's assets are liquidated in order to pay off the creditors;

(b) abolishes the retroactive bankruptcy rule, pursuant to which the court would establish a date prior to the declaration of insolvency on which the company effectively became insolvent. All acts and transactions completed in the period between the date of effective insolvency and the date of the declaration were void, even if entered into at arms' length and for good commercial reason or otherwise. Under the Insolvency Act, any transaction entered into during the two years prior to the declaration of insolvency that negatively affects the company's pool of assets may be rescinded (see 1.1 and 4.1 below for more detail);

(c) provides for a single receiver (the ***Receiver***) instead of the various categories of receiver under the old insolvency legislation;

(d) creates special commercial courts (*Juzgados de lo Mercantil*, the ***Commercial Courts***) for dealing with insolvency and other commercial issues; and

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1 The old Spanish general insolvency regime was set out mainly in:

(a) the Spanish Commercial Code of 1885 (Código de Comercio) and by its predecessor which dates all the way back to 1829; and

(b) the Suspension of Payments Act of 1922 (Ley de Suspensión de Pagos),

(together, the Old Insolvency Legislation).

There were also certain special insolvency rules applicable to, amongst others, insurance companies, credit entities and public work concessionaries. Finally, the Civil Procedure Act of 1881 (Ley de Enjuiciamiento Civil) governed procedural issues.

(e) includes the rules on cross-border insolvency proceedings introduced by Regulation 1346/2000 of the Council of the European Union, dated 29 May 2000 (the ***EU Regulation***).

Procedural issues not governed by the Insolvency Act are subject to the provisions of the Civil Procedure Act (*Ley de Enjuiciamiento Civil*) of 7 January 2000 (the ***CPA***). The CPA aims to speed up proceedings, make them less complex and more flexible, and to facilitate communication between the parties, and between the parties and the court. In particular, the CPA is designed to simplify the appeal procedure and enforcement requirements.

QUESTION 1

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1. The start and duration of the "twilight" period

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Length of the twilight period for setting aside transactions

1.1.1 Rescission regime under the Insolvency Act

One of the fundamental differences between the Insolvency Act and the Old Insolvency Legislation is the abolition of the retroactive bankruptcy rule and its substitution with a system based, not on the concept of breach of law, but economic harm **(the *Rescission Regime*)**.

The retroactive bankruptcy rule provided that, if supporting evidence was submitted to the court, it could establish a date (prior to the filing for insolvency) on which the company effectively became insolvent (i.e., when it ceased generally paying debts). All transactions completed during that period, even if at arms' length and for good commercial reason or otherwise, were null and void (as opposed to voidable).

The Rescission Regime is radically different. It represents a more pragmatic approach based on the concept of prejudice. Transactions that materially prejudice the value of the company's pool of assets may be rescinded, whether or not there has been intention to defraud, if completed within the two years immediately preceding the date of the declaration of insolvency.

1.1.2 Rescission claim under the Civil Code

In addition to the Recission Regime, any unsatisfied creditor may claim rescission of certain contractual or commercial operations on the basis of a fraud on creditors (*acción rescisoria por fraude de acreedores*). Insolvency proceedings under the Insolvency Act need not necessarily have been commenced; the claim must be made within four years of the date of the relevant contractual or commercial operation.

1.2 Personal liability

1.2.1 Liability under corporate law

(a) *Directors*

Under Spanish company law, directors of Spanish limited liability companies (i.e., *sociedades de responsabilidad limitada* or ***SL companies*** and *sociedades anónimas* or ***SA companies***) may be held jointly and severally liable to the company and its shareholders and creditors for any act or omission, which is:

(i) contrary to the provisions of Spanish company law;

(ii) contrary to the provisions of any other binding law;

(iii) contrary to the company's bye-laws, or

(iv) in breach of their duties to the company.

This liability is established by (Articles 133 of the Spanish Companies Act (*Texto Refundido de la Ley de Sociedades Anónimas*) **(*LSA*)** and 69 of the Spanish Limited Liability Companies Act (*Ley de Sociedades de Responsabilidad Limitada*) **(*LSRL*)**.)

(b) *De facto directors*

Law 26/2003, of 17 July (the ***Law 26/2003***) extended the duties and liabilities of directors established in the LSA to persons who, whilst not formally appointed as a director of an SA company, have acted *de facto* as if they were a director of an SA company.

Given that Article 69 of the LSRL refers to the rules of the LSA on directors' liability, it could also be argued that *de facto* directors of SL companies may also be held liable on the same basis.

(c) *Actions under corporate law*

Spanish company law provides for the following actions for a breach of director's duties:

(i) corporate action (*acción social*):

This is a contractual action that aims to protect and recover a company's assets damaged by the actions of the director(s). There is a limitation period of four years from the removal/dismissal of the director responsible.

(ii) individual action (*acción individual*):

This is an action in tort that aims to protect and recover the personal assets of the claimant to the extent that loss arises from the actions of the director(s). The limitation period is one year from the time the plaintiff had actual knowledge of the director's breach.

1.2.2 Liability under the Insolvency Act

The Commercial Court may declare directors and others liable as set out below during the qualification phase of the proceedings. An insolvency is deemed to "qualify" either: (i) upon the approval of a settlement agreement with creditors which proposes a reduction in excess of one-third of debts or a delay of payments in excess of three years, or (ii) when the liquidation phase is commenced. (For further information on the qualification and other phases in the insolvency proceedings process, refer to the Appendix to this chapter.)

(a) *Liability under Article 172.2 of the Insolvency Act*

The Commercial Court may declare the company's directors and liquidators (whether formally appointed or de facto), its legal representatives and other persons liable when:

(i) the "qualification" of the insolvency has taken place; and

(ii) the insolvency has been categorised as "guilty".

An insolvency is deemed "guilty" when, in the creation and worsening of the state of insolvency, there has been either *dolus* or gross negligence by the company, its legal representatives, directors or liquidators.

(b) *Liability under Article 172.3 of the Insolvency Act*

The Commercial Court may declare the company's directors and liquidators and its former directors and liquidators (in the two years prior to the declaration of insolvency),whether formally appointed or de facto, liable when:

(i) the qualification of the insolvency has taken place as a result of the commencement of the liquidation phase (but not as a result of the approval of a settlement agreement); and

(ii) the insolvency has been qualified as guilty.

QUESTION 2

2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above: -

(i) is any resulting liability against a director civil, criminal or both?;

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;

(iii) will liability attach to individual directors in proportion to their specific involvement?;

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and

(v) what defences, if any, will be available in relation to each offence?

Acts for which the director may be held personally liable?

2.1 Directors' liability under corporate law (civil liability)

2.1.1 Under Spanish company law, directors of both SA companies and SL companies may be held jointly and severally liable to the company and its shareholders and creditors for any act or omission which is:

(a) contrary to the provisions of Spanish company law;

(b) contrary to the provisions of any other binding law;

(c) contrary to the company's by-laws; or

(d) in breach of their duties to the company.

Directors' general duty

2.1.2 The principal general duty imposed on directors of Spanish limited liability companies is to act at all times in good faith, with the diligence of an "organised businessman and a loyal representative" (*ordenado empresario y representante leal*). This general duty applies to directors of both SA companies and SL companies (Articles 127 of the LSA and 61 of the LSRL, respectively).

2.1.3 As a consequence, directors must ensure that the company does not grant guarantees to secure the obligations of a third party (including a sister or parent company) when the guarantee is not for the corporate benefit of the company. If there is no corporate benefit or insufficient evidence of corporate benefit, the directors may incur personal liability to the company,, the shareholders and even third-party creditors. The existence of corporate benefit is a question of fact; no formal test exist. In the case of up-stream guarantees, the directors should ensure, at the very least, that:

(a) a particular benefit to the guarantor can be evidenced. This may be a direct benefit (e.g., participation in draw downs) or indirect (e.g., the possibility of the guarantor borrowing, in turn, from the borrower or funding the guarantor, say, through a capital increase, etc.); and

(b) giving the guarantee will not immediately cause the guarantor to become insolvent, by checking that there is no immediate risk of the guarantee being called. For example, if it is clear that the principal debtor is not capable of timely compliance with the obligations guaranteed, there would be a high probability of the guarantee being called immediately and the guarantor becoming insolvent (assuming assets were insufficient to cover the guarantee obligations guaranteed).

Directors' liability specifically related to the company's insolvency

2.1.4 In specific circumstances (including when the company breaches certain "subscribed capital to net equity ratios",[2] which are not then re-established within a certain period), directors may be held jointly and severally liable for all of the company´s debts (Article 262.5 of LSA and 105.5 of the LSRL). In particular, they will be held liable:

(a) if they fail to call a general shareholders' meeting to pass a resolution to wind up the company within two months of the breach of the "subscribed capital to equity ratio"; or

(b) if they fail to file for a judicial winding up or, if applicable, for a declaration of the company's insolvency (i) within two months of the general shareholders' meeting if the shareholders voted against the winding up or insolvency; or (ii) within two months of the proposed date of the general shareholders' meeting, if it was not held.

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[2] The subscribed capital to net equity ratio will be 2:1.

Additional duties of directors of SA companies

2.1.5 In addition and following the best practice guidelines already set out in the *Código de Olivencia*[3] and the recommendations of the Aldama Committee[4], Law 26/2003 has amended the duties of a director established in the LSA in order to increase the transparency of the SA companies.

2.1.6 The specific duties for directors of SA companies introduced by Law 26/2003 are as follows:

(a) Duty of fidelity

Directors must fulfil the duties imposed on them by law and by the by-laws of the company according to "*social interés*", that is, in the interests of the company (rather than in the interests of individual shareholders) (*fidelidad al interés social, entendido como interés de la sociedad*).

If a director appointed to the board by a shareholder acts or votes at a board meeting guided by the shareholder's particular interests, and those interests are contrary to the company's "*interés social*", the director may be deemed to be acting in breach (i.e., by breaching his obligation not to involve himself in a transaction in which he has conflicting interests and in breach of the duties inherent in his position, such as loyalty and fidelity to the company), if his actions were, in fact, harmful to the company, the other shareholders or the company's creditors.

The Spanish Supreme Court has, on a number of occasions, interpreted "*interés social*" to mean the aggregate interests of all the shareholders. However, the new regulation seems to open up the possibility of a broader interpretation of "*interés social*": a concept of the "corporation-institution", extending to the interests of all persons relating to the company (e.g., shareholders, employees, creditors, etc.). But as this provision has only recently been implemented, interpretation of this new provision needs to be provided by courts.

(b) Duty of loyalty

Law 26/2003 introduced a duty of loyalty aimed at avoiding conflicts of interest between directors and the company and also at impeding directors from carrying out unauthorised competing activities. The internal governance code for the board of directors of SA companies, implementation of which is compulsory, should determine the appropriate mechanisms for ensuring compliance with these duties. The duty of loyalty requires that:

(i) cdirectors must not use the company's name nor their position as director to carry out transactions on their own account or through persons connected with them.

(ii) a director must not, for his own benefit or for that of a connected person, invest in or carry out any transaction relating to the property

[3] Non-binding Spanish Code on Fair Corporate Governance published on 26 February 1988

[4] A committee of experts commissioned by the government, which published on 8 January 2003 a report on best practice and corporate governance.

of the company which he became aware of by virtue of his position as director and which was offered to the company or in which the company had an interest unless the company has, independently of any influence by the director, decided not to make the investment or enter into the transaction.

(iii) directors must inform the board of directors of any direct or indirect conflict of interest which they may have with the company. In the event of conflict, the director shall cease his involvement in the transaction causing of the conflict. Information on conflicts of interest between the company and its directors should be included in the annual report on corporate governance.

(iv) directors must notify the company of any shares that they hold in a company that has the same, analogous or complementary corporate objects (*objeto social*) of the company in which they are a director, and must also notify the company of any position held, or duties carried out, by him in that company.

(c) Duty of confidentiality

Even after their appointment has ceased, directors may must not disclose confidential information. Information, figures, reports and records that they are aware of as a result of their position may not be disclosed to third parties or otherwise divulged if this could be detrimental to the company's interests. When the director is a legal entity, the duty of confidentiality rests with its representatives.

2.2 Director's liability under the Insolvency Act (civil liability)

Liability under Article 172.2 of the Insolvency Act

2.2.1 As mentioned in 1.2.2 above, the Commercial Court may declare the directors of a company liable when the "qualification" of the insolvency has taken place and the insolvency has been categorised as "guilty".

2.2.2 An insolvency would be deemed "guilty" when, in the creation and worsening of the state of insolvency, there was either *dolus* or gross negligence by the company or its legal representatives, directors or liquidators (whether formally appointed or de facto).

2.2.3 An insolvency would be classified as guilty if:

(a) the company has substantially failed in its obligation to maintain proper accounts, or has committed any irregularity relevant to a person's understanding of the company's financial situation or assets;

(b) the company has filed false or misleading documents in support with the application for the declaration of insolvency or during the course of the insolvency proceedings. An application for insolvency must state whether the insolvency is actual or imminent and attach certain documents, including among others:

(i) a report containing both the financial and legal history of the company and the causes of its current financial situation; and

(ii) the book of accounts;

(c) the liquidation phase is opened following a breach of the settlement agreement by the company;

(d) the company has concealed its assets to the detriment of its creditors or has carried out any act that delays, obstructs or impairs the effectiveness of a seizure (*embargo*) or of an enforcement proceeding initiated or to be predictable initiated;

(e) during the two years prior to the declaration of insolvency, assets or rights of the company were fraudulently misappropriated; or

(f) before the declaration of insolvency, the company took legal action intended to present a misleading picture of its financial situation.

2.2.4 The existence of *dolus* or gross negligence is presumed (absent proof to the contrary) if the company or its legal representatives, directors or liquidators:

(a) have failed in their duty to apply for the insolvency. A company must apply for insolvency within two months of the date on which it knew, or should have known, that it had become insolvent;

(b) have failed in their duty to cooperate with the Commercial Court and the Receivers, have failed to provide the court with the necessary or relevant information in the general interests of the insolvency proceedings, or have failed to attend the creditors' general meeting either in person or by proxy; or

(c) have failed to produce annual accounts, have failed duly to submit them for auditing or, once approved, have failed to file them with the Commercial Registry (*Registro Mercantil*) in any of the three financial years leading up to the declaration of insolvency.

Liability under Article 172.3 of the Insolvency Act

2.2.5 The Commercial Court may declare the directors of a company liable when:

(a) the "qualification" of the insolvency has taken place as a result of the commencement of the liquidation phase.

The liquidation phase is commenced:

(i) at the request of the company, when the company itself applied for liquidation as part of its application for a declaration of insolvency and no settlement proposals have been approved;

(ii) when the company becomes aware that it is no longer able to comply with any settlement agreement;

(iii) when the Commercial Court so decides, based on any of the following circumstances:

(a) where no settlement proposal is filed or, if filed, is not admitted;

(b) rejection by the Commercial Court of any settlement proposal accepted at a creditors´ general meeting;

(c) the settlement agreement being void; or

(d) breach of the settlement agreement; and

(b) the insolvency is categorised as “guilty”.

2.3 Criminal liability

Under Spanish law, companies themselves cannot be criminally liable. Directors, as the natural persons representing a company, may be considered criminally liable for any criminal offence committed by the company.

Insolvency criminal offences

2.3.1 A director may be held responsible for the following criminal offences under the Spanish Criminal Code:

(a) Concealment of assets (*alzamiento de bienes*)[5].

Any person who, to the detriment of creditors, conceals or disposes of assets or enters into any obligation that delays, obstructs or impairs the effectiveness of a seizure (*embargo*) or the commencement of any actual or foreseeable executive (*procedimiento ejecutivo o de apremio*), judicial, extra-judicial or administrative proceedings.

(b) post-insolvency concealment and favouring creditors[6].

This offence arises where an insolvent company or person, which (or in respect of which someone) has successfully applied for insolvency, unlawfully disposes of assets or assumes further obligations with a view to favouring one or more creditors (whether preferred or otherwise) to the detriment of other creditors, if such action was taken without authorisation from the court or the insolvency administrators.

(c) Guilty insolvency[7].

This offence arises when the insolvency of the company was caused or aggravated with *dolus* by the company or persons acting on behalf of the company.

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[5] Article 257 of the Spanish Criminal Code.
[6] Article 259 of the Spanish Criminal Code.
[7] Article 260 of the Spanish Criminal Code.

(d) Inaccuracy of accounting documents[8].

This offence arises if any person files documents in the insolvency proceedings, which, to their knowledge, provide inaccurate data on the company's financial situation with the aim of improperly obtaining a declaration of insolvency.

Corporate criminal offences

2.3.2. The Spanish Criminal Code also imposes criminal liability on a director in respect of corporate criminal offences (i.e., those committed against the interests of the company and/or its shareholders). These are as follows:

(a) Forging corporate documents[9].

Any director (whether formally appointed or de facto) who forges the company's annual accounts or other corporate documents evidencing the legal or financial status of the company in a manner that is capable of causing economic loss to any person.

(b) Abusive resolutions[10].

Any person who, by exploiting his or her majority on the board or in general shareholders' meetings, passes a resolution with the intention of making a profit (either for himself or herself or for third parties), to the detriment of the other shareholders and which does not otherwise benefit the company.

(c) Harmful resolutions[11].

Any person who harms the company or any of its shareholders by imposing a resolution that has been adopted by fraudulent means (e.g., not giving voting rights to shareholders entitled to vote, etc.) and makes a profit out of such act (either for himself or herself or for third parties).

(d) Breach of shareholders' rights[12].

Any director (whether formally appointed or de facto) who prevents shareholders from exercising their political rights (e.g., right to information, right to take part in the running of the company, etc.).

(e) Breach of obligation to cooperate with any relevant authority[13].

Any director (whether formally appointed or de facto) of a company which is supervised by a regulatory authority, who impedes the supervision by the authority, or fails to provide relevant documentation.

8 Article 261 of the Spanish Criminal Code.
9 Article 290 of the Spanish Criminal Code.
10 Article 291 of the Spanish Criminal Code.
11 Article 292 of the Spanish Criminal Code.
12 Article 293 of the Spanish Criminal Code.
13 Article 294 of the Spanish Criminal Code.

(f) Illegal disposition or illegal contracting[14].

Any director (whether formally appointed or de facto) or any shareholder who, in abuse of his or her powers, illegally disposes of assets of the company or enters into any kind of obligation that results in an economic loss to the company or to the shareholders with the intention of making a profit (either for himself or herself or for third parties).

Civil or criminal liability?

2.4 Civil liability

2.4.1 Liability under Spanish company law and the Insolvency Act is civil.

2.4.2 The general view is that directors may be declared liable under both Spanish company law and the Insolvency Act in one set of insolvency proceedings. The aim under Spanish company law is to indemnify against loss caused by the directors to the company or third parties, whereas liability under Article 172.3 of the Insolvency Act (the ***Insolvency Liability***) is to indemnify creditors whose debts have not been paid from the liquidation of the company.

2.4.3 Whilst there is no legal ground for saying concluding that the Insolvency Liability should prevail over the directors' liability under the Spanish company law, it could be generally understood that the Insolvency Liability rules prevail. This is because, under the Insolvency Act, directors are liable to all creditors, whereas, under Spanish company law, directors are liable only to creditors whose claims have been affected by the loss suffered by the company or to creditors who have directly suffered loss themselves.

2.4.4 In most cases, creditors will wish to bring any claim as soon as possible and not wait for Insolvency Liability on the court's "qualification" of the insolvency. In addition, there are certain situations where the Insolvency Liability cannot be declared (e.g., if the insolvency proceeding concludes with a settlement agreement).

2.4.5 The general opinion is that the approval of a settlement agreement does not affect the liability of the directors. Therefore, creditors will be entitled to claim for any loss caused by the directors, even if a settlement is approved and regardless of how creditors voted. However, creditors can only claim for loss to the extent they are not compensated by the settlement agreement.

2.5 Criminal liability

2.5.1 The qualification of the insolvency as "guilty" does not bind the criminal courts. Consequently, the criminal court may decide independently whether a director has committed a particular criminal offence, punishable in accordance with the Spanish Criminal Code.

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[14] Article 295 of the Spanish Criminal Code.

2.5.2 In relation to the criminal offences described in 2.4 above, the Spanish Criminal Code expressly states the following:

(a) Concealment of assets: this criminal offence must be prosecuted even if insolvency proceedings are initiated after the offence was committed.

(b) Guilty insolvency: under no circumstances does the qualification of the insolvency in the insolvency proceedings bind the criminal courts.

2.5.3 Finally, it should be noted that a further criminal offence is committed if a person responsible for any criminal act carries out certain disposals or assumes additional obligations that decrease his/her assets so that that person becomes totally or partially insolvent, with the aim of avoiding any civil liability that might arise in connection with the original criminal act.[15]

Liability for the whole loss caused to the company or the deficit to creditors?

2.6 Lliability under corporate law

2.6.1 A fundamental distinction must be drawn under Spanish company law between:

(a) a corporate action (*acción social*): an action brought by the company or its shareholders, creditors and Receivers to protect and recover company assets damaged by the actions of director(s). Therefore, liability under this action is restricted to the damage caused to the company by the director(s);

(d) an individual action (*acción individual*): an action brought by the company's shareholders or creditors or other injured third parties to protect and recover the personal assets of the claimant to the extent damaged by the actions of the director(s). Therefore, liability under this action is restricted to the damage directly caused to the relevant claimant (i.e., the shareholder, creditor or third party) by the director(s).

2.6.2 Liability under Article 262.5 of LSA and 105.5 of the LSRL, is joint and several vis-á-vis any creditor for all of the company´s debts.

2.7 Liability under the Insolvency Act

Liability under Article 172.2 of the Insolvency Act

2.7.1 The judicial decision declaring the insolvency as "guilty" would order:

(a) the disqualification of those persons affected by the ruling from managing third-party assets or representing or managing any person/company for a period of between two and fifteen years, depending on the seriousness of both the infractions and the injury;

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[15] Article 258 of the Spanish Criminal Code.

(b) the removal of the rights of any persons affected by the qualification (including any persons found to have contributed towards the insolvency) as creditors of the company;

(c) that any rights or assets of such persons that may have unduly obtained from the assets of the company or received from the pool of assets be returned; and

(d) any loss or damage caused, be indemnified.

Liability under Article 172.3 of the Insolvency Act

2.7.2 Directors may be held liable for any deficit in the amount available to pay to creditors (i.e., all or part of the debts that remain unpaid after the liquidation of the assets of the company). Once the insolvency has been declared, the Commercial Court may order the seizure of rights or assets of the directors if, from the information available at the insolvency proceedings, it appears that: (i) the insolvency may be qualified as “guilty”; and (ii) the pool of assets of the company is insufficient to meet all of the debts.

2.8 Criminal offences

The penalties established in the Spanish Criminal Code for the criminal offences described in [2.1] above include the following terms of imprisonment and/or fines:

(a) concealment of assets: imprisonment for one to four years and a fine based on a period of 12 to 24 months.

(b) post-insolvency concealment and favouring creditors: imprisonment for one to four years and a fine based on a period of 12 to 24 months.

(c) guilty insolvency: imprisonment for two to six years and a fine based on a period of 8 to 24 months. The following would be considered in determining the severity of the sentence: (i) the detriment caused to creditors; (ii) the number of creditors; and (iii) the financial condition of the creditors.

(d) inaccuracy of accounting documents: imprisonment for one to two years and a fine based on a period of 6 to 12 months.

(e) forging corporate documents: imprisonment for one to three years and a fine based on a period of 6 to 12 months.

(f) abusive resolutions: imprisonment for between six months and three years or a fine of up to three times the profit obtained.

(g) harmful resolutions: imprisonment for between six months and three years or a fine of up to three times the profit obtained.

(h) breach of shareholders’ rights: a fine based on a period of 6 to 12 months.

(i) breach of obligation to co-operate with any relevant authority imprisonment for between six months and three years or a fine based on a period of 12 to 24 months.

(j) illegal disposal or illegal contracting: imprisonment for between six months and four years and a fine of up to three times the profit obtained.

Does liability attach to the directors in proportion to their specific involvement?

2.9 Liability under corporate law

2.9.1 The liability is joint and several where the directors act together. Directors are not protected from liability, even if the relevant action or decision of the board or individual director was adopted, authorised or ratified by a general shareholders' meeting shareholders of the company.

2.9.2 Likewise, directors' legal liability cannot be contractually modified, unless a more strict liability is agreed, and any corporate document or corporate arrangement aimed at limiting the director's liability is invalid.

2.9.3 However, a director will not be liable for the acts of other directors where the relevant director can demonstrate that:

(a) he was unaware of the act, decision or omission of the other director(s) for a reason other than his/her absence from a board meeting; or

(b) he was aware of the relevant act, decision or omission, but took all reasonable measures to prevent it from taking place, or (at least) expressly opposed the relevant board resolution.

2.10 Liability under the Insolvency Act

2.10.1 The general rule is that, if the company has committed any infringement under the Insolvency Act, all the directors will be liable. Accordingly, directors may be liable only when the insolvency has been qualified as "guilty" (see [2.1] above).

2.10.2 Pursuant to Article 172.2 the judicial decision would contain an order to indemnify any loss or damage caused, which implies that the Commercial Court might draw a link between the individual's involvement and the loss or damage caused.

2.10.3 The Insolvency Act does not include any provision that directly relates the Insolvency Liability (i.e., directors' liability under Article 172.3) to their specific involvement.

2.11 Liability under the Spanish Criminal Code

2.11.1 The general rule is that if the company has committed an infringement, all the directors (constituting the management of the company) may be criminally liable. Notwithstanding this, the general rule on criminal liability is that the court must have evidence of the degree of participation by the individual in question in the criminal offence (i.e., whether they were the perpetrator, an accomplice or were otherwise profiting from the crime). Consequently, the specific involvement of a director would be relevant to the sanction imposed.

Defences?

2.12 Under corporate law

2.12.1 The principal general duty imposed on directors of Spanish companies is to act at all times in good faith, fulfilling their position as a director of the company with the diligence of an "organised businessman and a loyal representative". This broad rule allows each director's behaviour to be assessed on a case-by-case basis. Spanish courts judge directors' diligence by demanding a high standard of behaviour.

2.12.2 The general defences available to directors are:

(a) that the director's behaviour was not negligent or did not breach his or her duties as a director of the company; and

(b) that the director did not take part in the damaging event and was either: (i) not aware of the existence of the damaging event; or (ii) took the necessary steps to avoid such damaging event.

2.13 Under the Insolvency Act

2.13.1 The Insolvency Act does not provide for any specific defences. However, it may be possible for directors to rely upon the defences provided for in Spanish company law, including the defence that the director did not take part in the damaging event, and was either: (i) not aware of the damaging event; or (ii) took the necessary steps to avoid such damaging event.

2.14 Under the Spanish Criminal Code

2.14.1 The general rule on criminal liability is that the criminal court must have evidence of:

(a) the individual having committed a specific criminal offence;

(b) the degree of participation by the individual in the criminal offence (i.e., whether they were the perpetrator, an accomplice or otherwise profited from the crime); and

(c) the existence of *dolus* or negligence in the commission of the offence.

2.14.2 Thus, any defence would be based on the absence of any of the above requirements.

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in respect of their actions during the "twilight" period

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above?

(c) Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors?

Others which may be held liable?

3.1 Liability under corporate law

3.1.1 Law 26/2003 extended the directors' duties and liabilities established in the LSA to those who, though not formally appointed as directors, act as *de facto* directors of a SA company.

3.1.2 The courts have not yet had an opportunity to construe this new provision and, therefore, it is not possible, at this stage, to assess to what extent directors' liability could be imposed. However, it is possible that liability could extend to: (i) those who were not directors but had management responsibilities in the company; (ii) directors of a parent company for acts carried out by directors of its subsidiaries in accordance with instructions from the directors of the parent company; and even (iii) a company which appoints a director later found to be liable.

3.1.3 Given that Article 69 of the LSRL refers to the rules of the LSA on directors' liability, it could be argued that *de facto* directors of SL companies may also be held liable.

3.2 Liability under the Insolvency Act

Liability under Article 172.2 of the Insolvency Act

3.2.1 Any person who, either through their *dolus* or gross negligence, co-operated with the company or its directors, legal representatives and their administrators or liquidators (whether in law or in fact) or their respective attorneys in carrying out any act that contributed to the qualification of the insolvency as "guilty" shall be deemed an accomplice.

3.2.2 When the insolvency is classified as “guilty”, the judicial decision containing the classification will also determine the persons affected by the qualification (including any accomplices). If any of the persons stated to be affected by the qualification are, in fact but not in law, the administrator or liquidator of the company, the ruling should justify why they, without legally being a director or liquidator of the company, in the court’s opinion acted *de facto* as if they were a director or liquidator.

Liability under Article 172.3 of the Insolvency Act

3.2.3 The Commercial Court may declare the company’s directors and liquidators and its former directors and liquidators (in the two years prior to the declaration for insolvency (whether formally appointed or de facto) (whether in law or in fact) liable when:

(a) the classification of the insolvency has taken place as a result of the commencement of the liquidation phase; and

(b) the insolvency has been classified as guilty.

3.3 Liability under the Spanish Criminal Code

Directors (whether formally appointed or de facto), and legal or voluntary representatives of a company can be held liable for any criminal offence committed by the company.

3.4 Managers’ liability

3.4.1 Managers are not personally liable to third parties for any acts and obligations undertaken on behalf of the company (even when they exceed the scope of their powers), provided they act within the scope of the company’s activities. Accordingly, managers can be held personally liable to third parties for any acts and obligations falling outside the company’s corporate objects/main activity. In any event, the company itself may claim damages from a manager that acts negligently or in breach of his or her duties to the company.

3.4.2 As a general principle, managers are also subject to the general duty to act at all times in good faith and honestly. The duties of a general manager (*director general*) (i.e., a non-executive director who is effectively in charge of running the company) and all other managers of Spanish companies are customarily set out in their employment agreements, with specific guidelines being given by the company’s management body and by market/sector general practice.

3.4.3 According to the Spanish Civil Code (*Código Civil*), the owners, directors or managers of a company (*dueños o directores de un establecimiento o empresa)* may be liable to third parties for activities carried out by the company’s employees (vicarious liability). However, the owner, director or manager may, in turn, bring a claim against the relevant employee(s) to recover any loss and/or expenses incurred as a result of the imposition of vicarious liability.

3.5 Regulated sectors

Directors and managers of companies operating in regulated sectors (such as banking, financial services, insurance, telecommunications, electricity and others) are subject to specific regulations, the breach of which may give rise to directors' and managers' liabilities.

In respect for which acts may other be held liable and what is the extent of their liability?

3.6 Liability under corporate law

3.6.1 According to Article 133 of the LSA, *de facto* directors may be held personally liable to the company, its shareholders and creditors for any act that is:

(a) contrary to the provisions of the LSA;

(b) contrary to the provisions of any other binding law;

(c) contrary to the relevant company's by-laws; or

(d) in breach of the duties that directors duly appointed have to the company.

3.6.2 The liability of appointed directors is joint and several and extends to acts and omissions, whilst the liability of *de facto* directors is personal and extends only to their acts.

3.7 Liability under the Insolvency Act

Please see [2.1] above.

3.8 Criminal liability

3.8.1 De facto directors and legal or voluntary representatives of a company can be held liable for any criminal offence committed by the company.

3.8.2 De facto directors can be held criminally responsible in the scope of insolvency proceedings.

3.8.3 Furthermore, the Spanish Criminal Code sets out three corporate criminal offences that may be specifically committed by the shareholders (namely, abusive resolutions, harmful resolutions and illegal disposal/contracting).

3.8.4 Please see [2.1] above for a description of both corporate and insolvency criminal offences

Is liability limited to their involvement in a particular transaction or more generally to the overall loss suffered by creditors?

3.9 Liability under corporate law

3.9.1 According to Article 133 of the LSA, the liability of *de facto* directors is limited to the loss caused by the director.

3.10 Liability under the Insolvency Act

Liability under Article 172.2 of the Insolvency Act

3.10.1 Please see [2.2. (b)] above.

Liability under Article 172.3 of the Insolvency Act

3.10.2 Directors and liquidators (whether formally appointed or de facto) - and those who were directors and liquidators (whether formally appointed or de factot) during the two years prior to the declaration of insolvency - may be held liable for any deficit in the amount available to pay to creditors (i.e., all or part of the debts that remain unpaid after the liquidation of the assets of the company). Once the insolvency has been declared, the Commercial Court may order the seizure of rights or assets of such persons if, from the information available at the insolvency proceedings, it appears that: (i) the insolvency may be qualified as "guilty"; and (ii) the pool of assets of the company is insufficient to meet all of the debts.

3.11 Criminal liability

Penalties under the Spanish Criminal Code for criminal offences include imprisonment and fines. Please see [2.8-2.10] above.

QUESTION 4

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4. Counterparties dealing with the company during the twilight period

(a) From the point of view of a counterparty dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside?

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

4.1 Rescission Regime

4.1.1 Transactions that prejudice the pool of assets of the company, whether or not there was an intention to defraud, are rescindable if completed within the two years immediately preceding the date of the declaration of insolvency. The Rescission Regime includes the following general rules:

(a) generally speaking, gratuitous transactions (i.e., transactions for no consideration or no material, consideration) are irrebutably presumed to be prejudicial;

(b) the same irrevocable presumption of prejudice applies to debts maturing after the insolvency is declared, but which are discharged prior to then;

(c) a rebutable presumption of prejudice is established in respect of:

(i) transactions for consideration entered into with persons or entities connected with the company; and

(ii) security created in respect of pre-existing obligations or new obligations assumed in substitution for pre-existing obligations;

(d) evidence of prejudice must be adduced in respect of other transactions; and

(e) transactions within the ordinary course of business of the company and completed on the company's normal terms and conditions are not rescindable. Equally, payments effected through clearing and settlement systems for securities and derivative instruments are not rescindable.

4.1.2 Each party to a rescinded transaction must return the asset received by it to the other party. For the purpose of this rule:

(a) if the asset to be returned is cash, this will give rise to a claim against the company which will qualify as a Debt of the Pool of Assets (see below) except where the rescinded transaction was entered into in bad faith, in which case it will rank as a subordinated claim (as a Debt of the Company, as defined below).

The Insolvency Act establishes a fundamental distinction between two basic types of debts of the company. Claims are deemed either to be liabilities of the pool of assets of the company (a ***Debt of the Pool of Assets***) or (the vast majority) remain liabilities of the company (***Debts of the Company***).

(i) Debts of the Pool of Assets either originate in the insolvency proceedings (i.e., following the declaration of insolvency) or relate specifically to the insolvency proceedings and must be expressed as such by statute. Debts of the Pool of Assets are payable out of the available assets of the company on their respective maturity date (except salary claims in respect of the last thirty days of work which, up to a maximum of two times the statutory minimum wage, are payable immediately) in preference to all other claims (other than secured claims to the extent they are covered by the secured asset); and

(ii) Debts of the Company are any other claims not qualifying as a Debt of the Pool of Assets;

(b) if an asset to be returned has been disposed of, the party obliged to deliver it shall, provided the asset was disposed of in good faith, satisfy its obligation by paying the value of the asset (as at the date of disposal plus interest accruing since then). Failing this, the party obliged to return the asset shall be liable for all loss (direct, consequential or otherwise) caused to the value of the pool of assets of the company as a result of the rescinded transaction.

4.2 Rescission claim under the Civil Code

According to the Spanish Civil Code (*Código Civil*) any unsatisfied creditor may claim rescission of certain contractual or commercial operations on the basis of a fraud on creditors (*acción rescisoria por fraude de acreedores*) and this remedy does not necessarily require the existence of insolvency proceedings under the Insolvency Act.

4.3 Defences

4.3.1 The Rescission Regime is based on the concept of prejudice.

4.3.2 The Insolvency Act provides for an irrebutable presumption of prejudice in the case of:

(a) gratuitous transactions. To avoid this presumption, the counter-party should ensure that the company obtains some benefit from the transaction; and

(b) payment obligations maturing after the date insolvency is declared, but which are discharged prior to that date. To avoid this presumption, a counter-party should include termination rights based on pre-insolvency situations. For example, in the context of a financing agreement, lenders could impose further and more sophisticated financial ratios which would be triggered before the borrower became insolvent.

4.3.3 The Insolvency Act provides for a rebutable presumption of prejudice in respect of:

(a) transactions entered into with persons or entities related to the company. In order to avoid this presumption, the counter-party should ensure that it is not a related entity for the purposes of the Insolvency Act, namely:

(i) a shareholder holding at least 10% of the share capital of the company (or 5% in the case of a listed company) and a shareholder with unlimited liability in respect of the company’s debts;

(ii) a director (whether in law or in fact), liquidator, or attorney of the company and or any person who was a director, liquidator or attorney of the company in the two years prior to the declaration of insolvency;

(iii) a company that forms part of the company's group or and a shareholder of such a company; and

(iv) a rebutable presumtion of related entity is established in respect of any assignee of a financing agreement granted in favour of any of the above persons/entities, if the assignment took place in the two years prior to the declaration of insolvency;

(b) security granted in respect of pre-existing obligations or in respect of new obligations assumed in substitution for pre-existing obligations. In the context of a debt restructuring, this presumption may mean lenders are required to ensure sufficient funds are available to the company so that it remains solvent for two years following completion of the restructuring.

4.3.4 Otherwise (and with the exception of transactions that are not rescindable at all), proof of prejudice is needed to rescind any other type of transaction. Consequently, it is a defence to show that no prejudice has been caused.

4.3.5 Finally, specific actions (*acciones de reintegración*), that are aimed at rescinding transactions negatively affecting the company's pool of assets, cannot be brought by Receivers to set aside a transaction that is subject to the law of another state unless the transaction could be set aside not only under Spanish law, but also under the law of the other state.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above)?

5.1 Actions under corporate law

(a) The corporate action (*acción social*):

As a general rule, a corporate action must first be approved in a general shareholders' meeting. However, shareholders holding in aggregate at least 5% of the voting rights are entitled to commence a corporate action, even where the general body of shareholders is opposed to it.

Creditors may also be entitled to bring a corporate action if the assets of the company are insufficient to pay its debts.

The Insolvency Act entitles Receivers to bring this action without the approval of the general shareholders' meeting.

(b) The individual action (*acción individual*):

This is an action which may be brought by the company's shareholders, creditors and injured third parties to protect and recover personal assets of the claimant to the extent damaged by the actions of the director(s).

An individual action does not require shareholder approval.

5.2 Actions under the Spanish Criminal Code

(a) Criminal denounce (*denuncia*).

A criminal denounce may be filed by any individual.

(b) Complaint (*querella*).

Shareholders of the company and injured third parties.

QUESTION 6

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6. Remedies: orders available to the domestic court

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

6.1 Civil infringements

Any individual who considers that he/she has suffered damage as a consequence of the directors' behaviour can file a civil claim in the Spanish civil courts.

The Insolvency Act provides a specific remedy to obtain the condeming of directors and others which is dealt by the judge in charge of the insolvency during the qualification phase of the proceedings.

6.2 Criminal offences

The filing of criminal offences may take place by either,

(a) filing a criminal denounce (*denuncia*) before the police, the public prosecutor or the criminal courts which thereby gives notice that a criminal offence may have has been committed but does not actually invoke the exercise of any remedy in court.

(b) filing a criminal complaint (*querella*) before the criminal courts, which notifies the court of the potential criminal offence and effectively exercises such criminal remedy.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European jurisdictions Article 6 of the European Convention of Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

7.1 General obligation to co-operate under the Insolvency Act

7.1.1 The Insolvency Act imposes the following obligations on an insolvent person/company:

(a) a general obligation to appear before the judge and the Receivers whenever requested and to co-operate and provide information where necessary or convenient in the interests of the insolvency proceedings; and

(b) a specific obligation to provide the Receivers with all documentation relating to the financial aspects of its business.

7.1.2 All the directors, liquidators and attorneys of the insolvent company (and any former directors, liquidators and attorneys of the company in the two years immediately proceeding preceding the declaration of insolvency) are required to comply with this obligation.

7.1.3 Although in the context of the general obligation to co-operate, the Insolvency Act does not impose any specific co-operation provisions, it does state expressly that co-operation and the provision of information may be requested wherever necessary or convenient in the interests of the insolvency proceedings. This is a question of fact, dealt with on a case-by-case basis.

7.1.4 A breach of the obligation to co-operate and/or provide information gives rise automatically to a rebutable presumption of guilty insolvency which may result in disciplinary or economic sanctions for the persons affected by the court decision that qualifies the insolvency as "guilty".

7.1.5 Any director of a company (whether formally appointed or de facto) who is subject to the supervision of a regulatory authority may commit a criminal offence if he impedes the supervision of the regulatory authority or neglects to provide any document.

7.2 Obligation to co-operate under the Spanish Constitution

7.2.1 The Spanish Constitution (the ***Spanish Constitution***) imposes an obligation to co-operate and provides that, during the course of trials and the execution of judgments, it is compulsory to assist judges and the courts alike.

7.3 Human rights

7.3.1 The Spanish Constitution provides that the principles relating to fundamental rights and liberties recognised by the Spanish Constitution shall be interpreted in accordance with the Universal Declaration of Human Rights and international treaties and agreements ratified by Spain. Once a treaty is officially published in Spain, it forms part of the Spanish legal framework and its provisions may only be repealed, amended or suspended pursuant to the provisions of the treaty or the general rules of international law.

7.3.2 On 16 September 1979 Spain ratified and became a party to the European Convention for the Protection of Human Rights and Fundamental Freedoms of 4 November 1950. Therefore, this Convention forms part of the Spanish legal framework and the principles relating to fundamental rights and liberties recognised by the Spanish Constitution are to be interpreted in accordance with this convention.

7.3.3 Moreover, provisions of the Spanish Constitution governing fundamental rights significantly reinforce the provisions of the Universal Declaration of Human Rights and the European Convention for the Protection of Human Rights and Fundamental Freedoms of 4 November 1950. The following fundamental rights protected by the Spanish Constitution may be relevant in the context of insolvency proceedings:

(a) Safeguarding and inviolability of domicile.

No entry or search may be performed without consent except with a court order or where a flagrant criminal offence is taking place.

(b) Safeguarding and inviolability of the secrecy of communications.

The secrecy of communications is guaranteed, in particular all postal, telegraphic and telephonic communications. No infringement of secrecy may take place without a court order.

(c) Freedom to set the state of residence and to relocate within the boundaries of the national territory and to enter and leave the national territory.

7.3.4 The Insolvency Act was enacted together with the Organic Law 8/2003, of 9 July[16] (the ***Organic Insolvency Act***) and provides the rules governing the impact of insolvency proceedings on fundamental rights. In light of the Organic Insolvency Act, the Commercial Court may make an order:

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[16] Organic laws (Leyes Orgánicas) are, amongst others, those relating to the development of fundamental rights and public liberties. The passing or amendment of organic laws requires an absolute majority of the members of the Spanish Parliament in a final vote on the bill as a whole.

(a) to enter and search the domicile of the company;

(b) to monitor the communications of the company (i.e. tapping communications), although the secrecy of the communications that do not relate to the insolvency proceedings must be preserved; and

(c) to require the company to stay in its place of residence, thereby restricting its freedom of movement.

7.3.5 These orders may be made in respect of the directors, liquidators and attorneys of the company and/or former directors, liquidators and attorneys who acted during the two years immediately preceding the declaration of insolvency.

7.3.6 In criminal proceedings, a number of fundamental rights are provided for by the Spanish Constitution. In particular every person has the right:

(a) to a fair trial which shall be safeguarded by judges and courts;

(b) to be tried by the judges and courts determined by the law;

(c) to a trial without undue delays and with full procedural guarantees;

(d) to the defence and assistance of a lawyer;

(e) to be informed of the charges;

(f) to use all evidence pertinent to the defence;

(g) not to make self-incriminating statements; and

(h) to the presumption of innocence

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, will apply to actions brought against directors (and/or others identified in question 3) in connection with the offences identified in question 2?

(b) Please indicate whether an appeal is available from the decision of the lower courts.

8.1 Limitation periods

8.1.1 Actions under corporate law

(a) The corporate action (*acción social*):

A limitation period of four years applies from the removal/dismissal of the director responsible.

(b) The individual action (*acción individual*):

A limitation period of one year applies from the time the plaintiff had actual knowledge of the director's breach.

8.1.2 Actions under the Insolvency Act

These are dealt with by the Commercial Court in charge of the insolvency itself during the qualification phase of the proceedings.

8.2 Appeals

8.2.1 Judgments rendered by Spanish First Instance Courts can always be challenged before the relevant Provincial Court by filing an appeal.

8.2.2 Judgments rendered by the Spanish Provincial Courts can be appealed (*recurso de casación*) before the Spanish Supreme Court if certain requirements are met such as that the amount of the claim is over 150,000.00 euros and that the appeal has a "cassational" interest (*interés casacional*).

QUESTION 9

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9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

9.1 Spanish companies law

Both the LSA and LSRL govern companies incorporated as SA companies or SL companies in Spain. Therefore, foreign companies are not subject to the provisions of the Spanish Companies companies law.

9.2 The Insolvency Act

9.2.1 Under the Insolvency Act, two types of insolvency proceedings may be opened in Spain: main proceedings of universal scope (the ***Main Insolvency Proceedings***) and the secondary proceedings of territorial scope (the ***Secondary Insolvency Proceedings***).

Main Insolvency Proceedings:

9.2.2 Main Insolvency Proceedings may be opened in Spain if the company's centre of main interest is located in Spain. "Centre of main interest" (the ***COMI***) is defined as the place where the company conducts the administration of its interests on a regular basis, as ascertainable by third parties. A company's COMI is presumed to be the place of its registered office.

9.2.3 Despite the definition, it is not clear what factors determine a company's COMI for the purposes of the Insolvency Act. The Insolvency Act does not include a list of points to be considered by the courts and there is no Spanish case law nor decisions by the European Court of Justice on the interpretation of COMI[17].

9.2.4 However, the English courts have issued several judgments including *Re Enron Directo, S.A.* (unreported 4 July 2002)[18], *Re BRAC Rent-A-Car* (7 January 2003), *Re Daisytek-ISA Ltd*. (16 May 2003)[19] and *Re Crisscross Telecommunications Group* (20 May 2003) which could possibly set a precedent, in practical terms, for the European Court of Justice and, consequently, for the Commercial Courts. Likewise, in December 2003[20], the Rome court issued the only decision issued by the Italian court with regard to the COMI.

9.2.5 Main Insolvency Proceedings will encompass all of the company's assets and will affect all creditors, wherever located, except where Secondary Insolvency Proceedings are opened, in which case the assets in that jurisdiction will be administered in those proceedings.

9.2.6 To discourage companies from forum shopping, the Insolvency Act states that a change in the registered office of the company carried out within the six months prior to the request of the insolvency will be disregarded for the purposes of the COMI presumption. Notwithstanding the above, forum shopping may well be encouraged by the liberal interpretation of the COMI's concept in the court decisions mentioned above. It may mean that it is not necessary for a company to move its entire business, assets or employees to avail itself of a different insolvency jurisdiction because all it needs to do is to transfer its head office functions, which in the modern world is relatively easy to do.

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[17] There is no definition of COMI in the EU Regulation but Recital (13) provides that it should correspond to "the place where the company conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties". There is also a rebuttable presumption that a company's COMI is the place of the registered office.

[18] Enron Spain, S.A. was a Spanish subsidiary of Enron that traded in Spain but whose headquarter functions were carried out in London. The English court held that Enron Spain S.A. had its COMI in England rather than in Spain. The decision was based on where the management decisions of the company were taken rather than where the day-to-day trading activities were carried out.

[19] Daisytek-ISA Ltd. was an English subsidiary of an American distributor of electronic office supplies. When the U.S. parent company filed for chapter 11 protection from bankruptcy, Daisytek-ISA Ltd. and its German and French subsidiaries applied for administration orders in England. The English court held that although the German and French subsidiaries had their registered offices and conducted their business abroad, they had their COMI in England because they were managed from Daisytek-ISA Ltd.'s head office. The decision was based on where the finance was arranged and where the contracts with key suppliers were negotiated and administered rather than where the services to customers were carried out.

[20] The Rome court held that three Luxembourg companies within the Cirio del Monte Group had their COMI in Italy rather than in Luxembourg. The presumption that the COMI should be where the company's registered office is located was rebutted on evidence that each company's strategic and directional centre was in Italy, the directors were Italian citizens and the management of the group was carried out in Italy.

9.2.7 When Main Insolvency Proceedings are opened in Spain the court involved will be the Commercial Court located where the company's COMI is, and Spanish law shall govern (subject to some exceptions) all aspects of the proceedings. The exceptions to the application of Spanish law include:

(a) rights *in rem* (mortgages, pledges) of creditors and third parties in respect of assets and rights of the company located within the territory of another state;

(b) retention of title rights in respect of assets sold to the company and located within the territory of another state;

(c) rights of the company in real estate assets, ships and aircraft subject to registration in a public register under the authority of another state, as well as, the validity of acts of disposal for consideration over these assets;

(d) rights under contracts in respect of real estate assets located in another state;

(e) rights under employment contracts governed by the law of another state;

(f) rights over securities represented by book-entries registered in another state;

(g) rights and obligations of the parties to a payment or settlement system or to a financial market regulated by the law of another state;

(h) declarative judicial proceedings (*juicios declarativos*) pending in another state and concerning an asset or a right of which the company has been divested;

(i) set-off rights where the set-off is governed (and permitted) by the non Spanish law applicable to the company's credit counterclaim[21]; and

(j) rights to set aside transactions. The specific actions (*acciones de reintegración*)[22] that are aimed at rescinding transactions negatively affecting the company's assets cannot be brought by the Receivers of Spanish insolvency proceedings to set aside a transaction that is subject to the law of another State, unless the transaction could be set aside not only under Spanish law, but also under the law of the other State.

Secondary Insolvency Proceedings:

9.2.8 To the extent that a company's COMI is not located in Spain, Secondary Insolvency Proceedings may be opened if the company has an establishment in Spain and regardless of whether main proceedings have been opened in the jurisdiction of the company's COMI. "Establishment" is defined as any place of operation where the company carries out a non-interim activity with human means and goods.

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21 Under Spanish law, once the insolvency has been declared, no set-off is allowed between the credits and debts of the company; however any right of set-off that has been perfected prior to the declaration of the situation of insolvency will be enforceable.

22 According to the Rescission Regime, any transaction negatively affecting the company's assets carried out within the two years prior to the declaration of insolvency may be rescinded, whether or not any fraudulent preference can be established.

9.2.9 Secondary Insolvency Proceedings are governed by the same rules as Main Insolvency Proceedings; however, they will apply solely to the assets of the company located in Spain. Accordingly, any restriction on creditors' rights deriving from a settlement agreement approved within the Spanish proceedings, such as a stay in payment or discharge of debt, may not apply to those of the company's assets not covered by the Spanish insolvency proceedings, except with the consent of all creditors interested.

9.2.10 If Main Insolvency Proceedings are opened, rules on the co-ordination of proceedings will be applicable. Where the request to open Secondary Insolvency Proceedings is made after the recognition of Main Insolvency Proceedings, there will be no need to re-examine the question of solvency. The competent Commercial Court will be that of the location of the establishment.

9.2.11 The EU Regulation establishes common rules for cross-border insolvencies throughout the European Union and is directly applicable in all European member states (with the exception of Denmark). Accordingly, the Insolvency Act will be directly applicable except in those cases that fall outside the scope of the EU Regulation (i.e., where the company is one of the corporate entities excluded from its application[23] or has its "centre of main interest" outside the territory of the European Union).

9.2.12 The aim of the Insolvency Act is to impose a framework for the efficient administration of cross-border insolvencies. In order for the framework to be successful and to reduce the scope for conflict between the parties involved so as to maximize the return for creditors, there needs to be co-operation between the relevant courts and co-ordination of the proceedings. The Insolvency Act attempts to address these issues in various ways. For example it sets out a regime, based on principles of mutual recognition and cooperation, for (i) the recognition and enforcement of foreign insolvency proceedings carried on outside the territory of the European Union; and (ii) the co-ordination of parallel insolvency proceedings. In addition, it states that the authority of the Commercial Courts is restricted, in international scope, to the issues that are closely related to those proceedings.

9.2.13 Whether the Insolvency Act, together with the EU Regulation, will create a streamlined insolvency regime applicable to cross-border insolvency proceedings remains to be seen. Principally, it will depend on the way the Commercial Courts interpret and apply its provisions.

9.3 Spanish Criminal Code

As a general rule, only criminal offences carried out in the Spanish territory are subject to the provisions of the Spanish Criminal Code.

[23] Insurance undertakings, credit institutions, collective investment undertakings and investment undertakings holding funds or securities for third parties are specifically excluded from the scope of the EU Regulation.

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above?

10.1 The strict legal regime on directors' liabilities introduced by Spanish company law caused a significant concern among directors of Spanish limited liability companies. As a consequence, a significant number of Spanish companies entered into directors' and managers' liability insurance policies.

10.2 In theory, directors and managers can protect themsleves by including an indemnity clause in their contract of service (directors) or contract of employment (managers). Nonetheless, this protection is invariably backed up by an insurance contract entered into by the company. Premiums payable under the insurance policies are paid by the companies.

10.3 Most of the largest Spanish companies (especially listed companies) have directors' and managers' liability insurance policies. The larger the company, the more likely that it will offer insurance cover. Insurance policies tend to include standard provisions and are not usually subject to negotiation between the directors or the managers and the insurance company.

10.4 A standard directors' and managers' liability insurance policy would generally have the following features:

(a) Parties: all senior executives and members of the board.

(b) Coverage: any act carried out by the directors/managers producing economic loss to either the company, its shareholders or creditors and not expressly excluded in the policy, specifically:

(i) directors' civil liability;

(ii) defence and court expenses; and

(iii) deposits/bonds required by the courts.

(c) Exclusions: these policies often exclude:

(i) acts of bad faith or wilful misconduct;

(ii) losses suffered by individuals or assets;

(iii) administrative fines;

(iv) actions taken by the majority shareholders; and

(vii) liabilities based on facts or infringements actually known by the directors/managers.

(d) Duration: an agreed contractual term. The insured director/manager will, therefore, be insured against any risk covered that is claimed within the contractual term.

QUESTION 11

11. How safe is it for directors and others to incur further credit during the twilight period?

11.1 When a company is in financial distress, no additional funding will normally be available unless it can ensure the future solvency of the company. This is because, pursuant to the Rescission Regime, transactions completed within the two years immediately preceding the date of the declaration of insolvency may be rescinded, whether or not there was intention to commit fraud.

11.2 Formally appointed directors may be held liable for any act or omission in breach of their duties to the company. De facto directors may be held liable for any act (but not omission) in breach of the duties that the directors duly appointed have to the company. All directors should ensure that any further credit incurred is, directly or indirectly, for the corporate benefit of the company and should be sufficiently comfortable that the transaction will not immediately cause the company to become insolvent (eg., because the company is incapable of timely compliance with its payment obligations).

11.3 In line with the above it should be noted that:

(a) directors and others may be held liable if the Commercial Court considers that in the creation or worsening of the state of insolvency, there was either *dolus* or gross negligence by the company or its legal representatives, directors or liquidators (whether in law or in fact) ; and

(b) directors (formally appointed or de facto) may be held criminally liable if the insolvency of the company was caused or aggravated with *dolus* by the company or by the directors.

11.4 Finally, directors and others may be held liable if they do not provide the lender with accurate and true information about the financial situation of the company. In this regard it should be noted that:

(a) the Insolvency Act provides an irrebutable presumption of *dolus* or gross negligence if before the declaration of insolvency, the company took legal action in order to mislead persons as to its financial situation; and

(b) the Spanish Criminal Code also makes it a criminal liability for any director (formally appointed or de facto) to forge the company's annual accounts or any other corporate document showing the legal or financial status of the company in a way that is capable of producing economic loss to any person.

Can an unconnected third party rely on the validity of transactions entered into by the company (in particular guarantees and securities) during the twilight period?

11.5 Under Spanish law, a distinction is made between a personal guarantee (payment undertakings) and a "real" guarantee (i.e. security over assets).

Personal guarantees

11.6 In an insolvency scenario, the position of the guaranteed creditor will vary depending on whether or not the granting of the guarantee is or is not rescinded by the Commercial Court pursuant to the Rescission Regime (as set out in [4.1 - 4.2] above):

(a) Where a guarantee has been granted within the two years prior to the declaration of insolvency and negatively affects the guarantor's assets, the guarantee may be rescinded by the Commercial Court. There is an irrebutable presumption of damage in cases of disposals for no consideration; an upstream guarantee may be included in this category. If the Commercial Court declares the transaction rescinded, the transaction will be reversed. It is important to highlight, however, that any loss suffered by the beneficiary of the guarantee as a result of the reversal will be paid upon the reversal of the transaction as it will qualify as a Debt of the Pool of Assets (as opposed to a Debt of the Company), except where the Commercial Court declares the beneficiary acted in bad faith, in which case the claim of that beneficiary will be subordinated to the claims of other creditors.

(b) Where the guarantee has not been granted within the two-year period or is not considered to have caused economic damage to the guarantor's pool of assets, the guaranteed creditor shall be considered to be an ordinary creditor (i.e., Debts of the Company). In this case, the effect that insolvency proceedings may have on guaranteed creditors varies depending on the manner in which the insolvency proceedings are brought to an end. If there is:

(i) a settlement agreement, guarantee claims will be subject to the settlement agreement; or

(ii) a liquidation, guarantee claims will be subject to the general rules on the ranking of creditors.

11.7 Upon the declaration of insolvency, a creditor cannot initiate judicial or non-judicial enforcement procedures (with certain exceptions such as labour debts) and outstanding enforcement proceedings shall be suspended.

Security

11.8 The effect that insolvency proceedings may have on secured creditors (provided that the security is not rescinded under the Rescission Regime), varies depending on how the insolvency proceedings are brought to an end:

(a) Where the proceedings end with a settlement agreement, secured creditors will not be subject to the settlement agreement unless they voted in favour of the settlement agreement that is finally approved, in which case they will lose their preferred status and be bound by the settlement agreement.

(b) Where the proceedings end with liquidation, secured creditors must be paid out of the proceeds of sale from assets subject to their security (usually by means of public auction). If secured creditors are not paid in full from the secured assets, they are treated as ordinary creditors (i.e., Debts of the Company) for the unsecured element of their claim and subject to the usual rules on priority and ranking of creditors. However, please note that:

(i) the judicial administrators may choose to pay secured amounts outstanding out of assets other than the secured assets. Any non matured secured claims are payable as a Debt of the Pool of Assets ranking ahead, of the Debts of the Company; and

(ii) the court may authorise the sale of a secured asset with the security attached, the transferee assuming (as assignee) liability for the secured obligation (so that the payment obligation of the purchaser is not limited to the value of the secured asset).

11.9 Upon the declaration of insolvency, creditors cannot generally initiate judicial or non-judicial enforcement procedures and outstanding enforcement proceedings are suspended.

11.10 In relation to security over an asset that is necessary for the performance of the company's business, the judicial declaration of insolvency:

(a) prevents the enforcement of the security until the earlier of either (i) the approval of a settlement agreement which does not affect the right to enforce the relevant security; or (ii) the expiration of one year from the declaration of insolvency (if liquidation has not been initiated) (the ***Suspension Period***); and

(b) suspends any ongoing enforcement proceedings for the duration of the Suspension Period unless (i) the announcement of an auction has been made prior to the declaration of insolvency; and (ii) the asset concerned is not necessary for the continuation of the business of the company.

APPENDIX: SUMMARY OF THE INSOLVENCY PROCEEDINGS

1. THE INSOLVENCY DECLARATION

Requirements to obtain the insolvency declaration.

Under the New Insolvency Act a debtor is considered legally insolvent when it *can not comply regularly with its due obligations."* However, questions arise as to the legal meaning of,

(a) "*inability to comply*"

Under Spanish law, economic insolvency is not the same as legal insolvency; not every cessation of payments will be a symptom of insolvency. A debtor is not incapable of paying when it can organise payment (i.e. through the funding of the parent company, etc). The mere cessation of, or delay in, payments does not provide grounds to initiate insolvency proceedings;

(b) "*regularly*"

Regularity is not defined. It is undoubtedly broader than a breach of a single obligation. Regular implies a general and repeated cessation of payments; and

(b) "*due*"

Under Spanish law, obligations are due when fulfilment can be claimed in court.

1.2 Voluntary and Necessary Insolvency

There are two types of insolvency depending on who applies. Insolvency may be applied for by the debtor (***Voluntary Insolvency***) or by its creditors (***Necessary Insolvency***):

(a) *Voluntary Insolvency*

The Debtor debtor is entitled to initiate Voluntary Insolvency proceedings in the event of imminent, and not actual, insolvency.

(b) *Necessary Insolvency*

In order to file for Necessary Insolvency, a creditor must provide evidence of:

- (i) actual, and not potential or imminent, insolvency;
- (ii) the concurrence of, at least, one of the following:
  - (a) general cessation of payments by the debtor;
  - (b) the assets of the debtor having been generally seized or that there are insufficient free assets to be seized;

(c) a concealment of assets or an accelerated or defeated liquidation of assets; or

(d) a general breach during the three months preceding the filing of the insolvency application of either tax obligations, Social Security contributions and salaries, compensations or other amounts due to employees, provided, however, that the debt upon which the petition is founded must not have been acquired by the creditor, after becoming due and payable, during the six months period prior to the filing for insolvency.

1.3 Application period

The debtor is obliged to apply for insolvency within two months following the date on which it knows, or should had known, that it became insolvent. It is presumed that the debtor was aware of its insolvency if any of the circumstances that justify the filing for a Necessary Insolvency apply.

1. INSOLVENCY PROCEEDINGS

1.1 Background

The New Insolvency Act unifies and simplifies the insolvency procedures by establishing a unique procedure divided into the following phases:

(a) the filing of the insolvency application (the ***Application***);

(b) the common phase (the ***Common Phase***);

(c) the settlement and/or liquidation phase; and

(d) the qualification of the insolvency.

1.2 The Application

(a) The Application for insolvency must be in writing and must state whether the insolvency is actual or imminent and attach a number of documents including, among others:

(i) a report containing the financial and legal history of the debtor and the causes of the current financial situation; and

(ii) the books of accounts.

(b) The Application is filed,

(i) with the Commercial Court in the place where the debtor has its centre of main interests, presumed to be the city where the company has its registered address; or

(i) in the event that insolvency affects a number of companies forming part of the same group, the application is filed with the Commercial Court in the location where the parent company has its registered address.

(c) In the event of a Necessary Insolvency, the debtor may agree or oppose the Application. If the Debtor opposes the Application, it is obliged to deposit in court the amount of the outstanding debts which gave ground to the filing.

(d) If the Application is founded, the Commercial Court will make an insolvency order which, among other matters, will decide:

   (i) the effect of the insolvency declaration on the powers to manage the business and/or dispose of its assets;

   (ii) the interim measures necessary to secure the integrity of the debtor's estate;

   (iii) the identity and powers of the Receivers.

   (A) Under the New Insolvency Act, there will generally be three Receivers:

   - a lawyer with, at least, 5 years effective experience;

   - a chartered accountant with, at least, 5 years effective experience; and

   - a creditor with an ordinary or preferential claim, (but not a secured claim).

In the event of summary insolvency proceedings (generally reserved for debtors with aggregate liabilities below €1 million), only one Receiver will be appointed.

   (B) The appointment of Receivers for certain types of debtors is subject to special rules. Where the debtor is:

   - a listed company, the chartered accountant will be replaced by a representative of the Spanish Securities Market Commission;

   - a credit institution, the chartered accountant will be replaced by a representative of the Spanish Guarantee of Deposits Fund; and

   - an insurance company, the chartered accountant will be replaced by a representative of the Spanish Insurance Compensation Consortium.

1.3 Common Phase

Once the court has declared the debtor insolvent, the Common Phase of the procedure commences. The Common Phase comprises:

(a) the preparation of a report by the Receivers (the ***Report of the Receivers***) containing, at least:

   (i) an analysis of the contents of the debtor's report;

(ii) the status of the debtor's accounts;

(iii) a summary of the decisions taken and acts performed by the Receivers;

(iv) the following documents:

(A) a list of the debtor's assets and rights;

(B) a list of the debtor's creditors; and

(C) an evaluation of the settlement proposals (if any) that have been submitted; and

(v) an analysis of the situation of the debtor's estate;

(b) the publication of the Report of the Receivers; and

(c) the granting of a certain time period so that the list of assets or the list of the creditors can be challenged,

(ii) within the 10 days following receipt of the Report of the Receivers;

(ii) with the aim of,

(A) including/excluding any right or asset;

(B) increasing/decreasing the value of any asset or right; and

(C) including/excluding any claim or changing the classification of the claim; and

(iii) by commencing a parallel procedure known as an insolvency incident (an ***Insolvency Incident***). An Insolvency Incident is a summary proceeding, the object of which is to discuss particular claims before the Commercial Court. The Insolvency Incident comprises the following phases:

(A) the filing of a claim, subject to the same requirements as any other claim;

(B) the filing of a writ of defence within the 10 days following notice of the decision admitting the claim;

(C) the trial, during which the parties place all evidence that they deem appropriate and pertinent before the Commercial Court; and

(D) the handing down of a judgment which, generally, cannot be appealed.

1.4 Settlement phase

(a) *General considerations*

One of the objects of the insolvency proceedings is to bring about the possibility of a settlement (the ***Settlement***) either in terms of a reduction in the amount of the company's debts and/or the delay in the payment of the debts. The Settlement phase only takes place if,

(i) the debtor has not requested liquidation; or

(ii) if a proposal for a Settlement has not been approved during the Common Phase.

(b) *Content of the Settlement*

The Settlement is limited in its scope, given that it:

(i) may include a reduction (*"quita"*) in the amount of the debts and/or the delay (*"espera"*) in the payment of the amounts due. However, common ordinary debts cannot be reduced by in excess of 50% of the amount of each debt, and/or subject to a delay in excess of 5 years;

(ii) may propose different alternatives for different creditors or debts, including the conversion of debts into equity;

(iii) may propose the sale of assets or rights devoted to the business activities or of certain business units to specific individuals; and

(iv) must include a payment plan or feasibility plan, the latter only where fulfilment of the Settlement is subject to the income obtained from the continuation of the business.

However, the Settlement cannot consist of:

(v) the assignment of assets or rights to creditors;

(vi) the liquidation of the entire estate of the debtor; or

(vii) the modification of the classification of claims.

(c) *Consequences of the Settlement*

The approval of any Settlement:

(i) is fully effective from the date on which the Settlement is approved by the Commercial Court;

(ii) triggers the cessation of the consequences of the insolvency, which are substituted by the specific measures approved by the Commercial Court;

(iii) generally terminates the appointment of the Receivers, unless and to the extent otherwise provided for in the Settlement; and

(iv) the Settlement,

(A) binds the debtor and the common ordinary and subordinated creditors;

(B) does not bind secured creditors unless they voted in favour of the Settlement or otherwise ratified, or adhered to, the Settlement; and

(C) does not affect or impair rights of creditors who voted against the Settlement in respect of third parties jointly liable with, or guarantors of, the debtor.

(d) *Settlement proceedings*

Settlement proposals can be filed with the Commercial Court,

(i) any time between the final date for creditors to give notice of their claims and the final date for challenging the Report of the Receivers; or

(ii) between the opening of the Settlement Phase phase (which takes place after the approval by the court of the Report of the Receivers) and 40 days prior to the date appointed for the creditors' meeting. The Receivers are obliged to prepare a report on the various Settlement proposal(s) filed.

Once filed, the proposals are analysed at a creditors general meeting. Only one Settlement proposal can be approved by a majority of votes of, at least, half of the ordinary claims of the creditors. However, if the Settlement proposes that full payment of the debts is to be completed within three years or, alternatively, that immediate payment of due ordinary debts are to be reduced by no more than a 20%, a simple majority of ordinary debts will be sufficient to approve the Settlement. Notwithstanding approval, the Debtor, its shareholders or even the creditors are entitled to challenge the Settlement by initiating an Insolvency Incident, at which the Commercial Court will definitively approve or reject the Settlement.

It is important to note that,

(iii) once the Settlement has been complied with by the debtor, the debtor is entitled to request the Commercial Court to issue a judicial declaration of compliance with the Settlement; and

(iv) conversely, any creditor may request the Commercial Court to declare that the debtor has breached the Settlement. If the request is successful, the Commercial Court will order the rescission (i.e. termination) of the Settlement.

(d) *Advanced Settlement proposal*

In addition, the Debtor is entitled to file advanced Settlement proposals (each one, an ***Advanced Settlement Proposal***) at any time until the expiry of the period during which creditors can give notice of their claims. An Advanced Settlement Proposal can only be filed if the debtor has not:

(i) breached its obligation to deposit its annual accounts during the last three financial years;

(ii) been declared insolvent during the three years immediately preceding the conclusion of the former insolvency proceedings; and

(iii) paid obligations prior to their maturity or carried out acts qualifying as a fraud on creditors.

Advanced Settlement Proposals are also subject to the Report of the Receivers, and can be approved any time before the end of the period for challenging the list of assets. If approved, the Commercial Court will not need to initiate the Settlement phase.

1.5 Liquidation phase

Liquidation only takes place:

(a) at the debtor's request, in the context of a Voluntary Insolvency, if:

(i) the debtor applies for liquidation as part of its Application; and

(ii) no Settlement proposals have been approved;

(b) when the debtor becomes aware that it is unable to comply with the terms of an approved Settlement; or

(c) if the Commercial Court decides, based on:

(i) failure to file a Settlement proposal or failure to admit any of those filed;

(ii) rejection by the Commercial Court of any Settlement proposal accepted at a creditors' general meeting;

(iii) the Settlement being void; or

(iv) a breach of the Settlement.

Liquidation triggers the suspension of the debtor's powers to administer the business and/or to dispose of its assets, as well as the winding up of the debtor and the maturity of any debt.

Moreover, liquidation provides for the possibility of establishing a liquidation plan subject to the Commercial Court authorisation.

1.6 Qualification of insolvency

Insolvency is subject to qualification, either (i) upon approval of a Settlement which foresees a reduction in excess of one -third of the amount of the debts or a delay of payments in excess of three years, or (ii) when the debtor enters into liquidation.

Insolvency can be qualified as either fortuitous or guilty.

(a) An insolvency is considered guilty where the debtor:

   (i) has breached its accounting obligations;

   (ii) has filed false or untrue documents with the Application;

   (iii) has breached the Settlement; or

   (iv) has concealed assets.

(b) The qualification of insolvency as guilty may disqualify the individuals who managed the debtor from administering assets for a 15 year period, and declare them personally liable for all or part of the debts.

UNITED STATES OF AMERICA

Background Discussion of Applicable Law.

A Multiplicity of Jurisdictions.

Any discussion of the potential liability of officers and directors of an insolvent business entity in the United States must first recognize the multiplicity of jurisdictions whose law may apply to address the various issues.

Generally, the internal affairs of a business entity are governed by the law of its jurisdiction of formation. This proposition is commonly known as the internal affairs doctrine. Accordingly, Delaware law will govern issues pertaining to the internal affairs of a corporation formed under Delaware law, and New York law will govern the affairs of a corporation formed under New York law, and so on. The internal affairs of a corporation or limited liability company include issues of governance, capitalization, dividends and the fiduciary duties of its managers.

Other important issues that are discussed in this paper may not fall within the internal affairs doctrine, because the issue is not limited to the internal workings of the entity. For example, what law governs a claim that the transfer of corporate property to its corporate parent for less than fair value should be avoided as a fraudulent transfer where the corporation is formed in Delaware, its main office is in New York, the transferred property is located in California and the complaining creditor brings suit in Texas? The point of the question is that in the United States, choice of applicable law can be a complicated matter and there are fifty-two separate jurisdictions (each of the states, Federal law and the District of Columbia).

Generally, this paper will focus on the corporate law of Delaware, because Delaware remains a popular jurisdiction for incorporation, and on Federal law. Federal law is of importance because many of the issues raised in this paper are litigated and resolved in the United States Bankruptcy Court, not in the state courts. This paper will highlight noteworthy State law decisions other than Delaware when appropriate.

Practice Consideration: Counsel must always be aware of the state of incorporation or formation of the relevant business entity. The law of the state of incorporation (or formation in the case of a limited liability company or limited partnership) will govern many important questions relating to the potential liability of its officers and directors.

Statutory References.

In 1978 the U.S. Congress passed the Bankruptcy Reform Act of 1978, replacing the Bankruptcy Act of 1898. The Reform Act is commonly referred to as the **United States Bankruptcy Code** and is codified at Title 11, of the United States Code. In these materials, the **Code** refers to the United States Bankruptcy Code. The Code is administered by the United States Bankruptcy Court, a federal court ancillary to the Federal District Court. Many of the issues discussed in these materials are played out in the United States Bankruptcy Court under the Code, either because insolvent business entities voluntarily seek the protection of the Bankruptcy Court or because unpaid creditors of the insolvent entity file an involuntary petition against the debtor under the Code. The Code, of course, is Federal law and is therefore uniform, in theory, throughout the United States. As with all Federal law, however, there are differences among the federal courts in their interpretation and application of the various provisions of the Code.

After the Code, one of the most significant statutory provisions of relevance in the context of an insolvent business entity is the **Uniform Fraudulent Transfer Act (“UFTA”).** UFTA was promulgated by the Commissioners on Uniform Laws and has been enacted in substance in 42 States and the District of Columbia. Most of those states that have not enacted UFTA have an earlier version of the Uniform law known as the **Uniform Fraudulent Conveyance Act**. Both laws address the circumstances under which creditors of an insolvent entity may avoid (or undo) a conveyance of property or the incurrence of an obligation by the insolvent entity. UFTA is state, not Federal law. Counsel must be aware of local variations in the enactment of UFTA that may be applicable.

Every state has enacted at least some articles of the **Uniform Commercial Code ("UCC")**, and all have adopted Article 9 of the UCC, as amended in 2000 ("Revised Article Nine"). The UCC is cited in the text in reference to the rights of sellers of goods to an insolvent buyer. Revised Article Nine of the UCC governs the grant and perfection of security interests in certain tangible and intangible personal property.

As noted above, the corporation codes of the various states will also play a significant role in determining the potential liability of the officers and directors of an insolvent business entity.

Business Entity Nomenclature.

Most corporations formed in one of the fifty States and the District of Columbia are governed by a Board of Directors. Some states permit the corporation to be governed directly by the shareholders, but subject to a limit on the number of shareholders in the entity. The Directors are elected by the shareholders of the corporation. The Directors set the basic policy and direction of the entity and usually must approve all material decisions, such as the incurrence of secured debt or the sale of assets. The Directors also adopt and occasionally amend the corporation's by-laws, which are the procedural rules for the governance of the corporation. As will be seen below, a corporation's by-laws may have substantive significance.

The business of the corporation is managed by its officers and executed by its employees and other agents. The officers are elected or appointed by the Directors of the corporation (or the shareholders if the corporation is governed directly by its shareholders). Most states require that a corporation have a President, Treasurer and Secretary. The corporation may have numerous inferior officers, such as Vice Presidents.

The limited liability company is becoming an increasingly popular form of business entity in the United States. Like the corporation, the limited liability company generally shields its owners from liability for the debts of the entity. Also, the limited liability company is a "flow through" entity for U.S. Federal income tax purposes. The income and loss of the entity is passed through to its owners and is not taxed at the entity level. The availability of flow through tax status in the corporate form is more limited under the U.S. Internal Revenue Code and this fact alone accounts for much of the popularity of the limited liability company.

Like a corporation, the limited liability company is formed under the laws of one of the fifty states. The LLC, as it is usually referred to, may be managed by its members or by managers, depending on the terms of its Operating Agreement. The members of the LLC are analogous to the shareholders of a corporation. The managers of the LLC, if any, are analogous to the directors of a corporation. An LLC may also have officers, appointed by the members or the managers.

Practice Consideration: Control is the key concept to remember in the context of a discussion of the possible liability of officers, directors and managers. Fiduciary duties and potential statutory liabilities follow control. Whether one is an officer, director, controlling shareholder or even a lender, the risk of liability follows and flows from control of the insolvent entity.

QUESTION 1

1. The start and duration of the "twilight" period.

What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

The "Twilight" period during which the directors or managers of a business entity face substantially increased risk exists for so long as the entity is insolvent. The increased risk of liability also exists in the context of a proposed transaction that may render the entity insolvent.

Courts in the United States generally have two choices in determining whether a corporation is insolvent, unless the choice is determined by an applicable statute. The balance sheet test determines whether a company is insolvent based strictly upon the company's balance sheet. Under the balance sheet test, a company is insolvent if its assets, fairly valued, do not exceed the amount of its liabilities. Under the equity test, an entity is insolvent if it is not meeting its obligations generally as they come due, regardless of the condition of the entities' balance sheet.

For example, under UFTA, a version of which is in effect in 43 jurisdictions, insolvency is defined using the balance sheet test, but is presumed if the equity standard is satisfied. Under the United States Bankruptcy Code, an involuntary petition for relief filed against a debtor shall be granted if the entity is not paying its debts generally as they come due.

The Delaware Chancery Court in two recent cases, both involving actions brought by shareholders against directors for breach of fiduciary duties, has defined how to determine insolvency. In *Francotyp-Postalia Ag & Co. v. On Target Tech., Inc.,* No. 16330, 1998 WL 928382 (Del. Ch. Ct. Dec. 24, 1998), the court rejected the balance sheet approach and stated that a corporation is insolvent "when a corporation is unable to meet its debts as they fall due in the usual course of business. *Id.* at *5. The Court rejected the balance sheet approach because it "ignores the realities of the business world in which corporations incur significant debt in order to seize business opportunities. [This approach] could lead to a flood of litigation arising from alleged insolvencies and to premature appointments of custodians and potential corporate liquidations." *Id.* In *Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386 (Del. Ch. 1999), the court adopted the equity approach in defining insolvency without a discussion of any alternatives. These cases indicate that Delaware has determined that a corporation becomes insolvent when it is "unable to pay its debts as they fall due in the usual course of business." *Id.* at 417.

QUESTION 2

2. Actions Potentially Giving Rise to Liability for Officers and Directors.

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?

(b) In relation to each act identified in (a) above:-

(i) is any resulting liability against a director civil, criminal or both?

(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?

(iii) will liability attach to individual directors in proportion to their specific involvement?

(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?

(v) what defences, if any, will be available in relation to each offence?

The Trust Fund Doctrine; Director Fiduciary Duties in the Vicinity of Insolvency and the Business Judgement Rule.

(i) Introduction.

Counsel representing an insolvent corporation or a corporation about to undertake a transaction that may render it insolvent must now reckon with the judicially recognized duties owed by the corporation's directors to the company's creditors. The duty of directors to creditors in the context of an insolvent entity has long been recognized in the courts. The earlier cases find the duty in the elementary rules of priority: The claims of creditors take priority over the claims of equity. These cases often describe the duty in the context of the Trust Fund Doctrine, discussed further below. More recent precedent, especially that from Delaware or dealing with the internal affairs of Delaware corporations and applying Delaware law, have expressed the obligations of directors in traditional corporate law terms. These courts have identified a fiduciary duty of directors owed to creditors and have applied familiar Delaware corporate law concepts such as the business judgement rule to determine whether liability exists.

(ii) The Trust Fund Doctrine.

The trust fund doctrine posits that the assets of an insolvent corporation are held in trust for the creditors and that the directors are the trustees. Cases espousing the doctrine are legion: *See* cases cited at *Fletcher Cyclopedia Corporations*, Vol. 15A §7369 - §7371; *In re Brockway Mfg. Co.*, 89 Me. 121, 126 (Me. 1896) (adopting the "plain proposition that the stock and property of every corporation is to be regarded as a trust fund for the payment of its debts, and that its creditors have a lien thereon and the right to priority of payment over any stockholder"); . *Pepper v. Litton*, 308 U.S. 295, 307, 60 S.Ct. 238, 245 (1939) ("While normally [the] fiduciary obligation is enforceable directly by the corporation, or through a stockholders derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the [bankruptcy] trustee".) *See also, Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945) ("The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors . . . ", *quoting with approval Arnold v. Knapp*, 75 W.Va. 804, 811, 84 S.E. 895, 899 (1915); *F.D.I.C. v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982), *cert. denied*, 103 S.Ct. 2089, 461 U.S. 928 (1982) (same); *Automatic Canteen Co. of America v. Wharton*, 358 F.2d 587 (2d Cir. 1966) (same applying Indiana law); *U.S. v. Spitzer*, 261 F.Supp. 754 (D.C.N.Y. 1966) (same applying New York law); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506, (2d Cir. 1981) *cert. denied*, 102 S.Ct. 1614, 455 U.S. 990 (under New York law, duty to creditors arises upon solvency, not merely when failure is imminent and foreseeable); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-88 (Del. Ch. 1992) (fiduciary duty arises upon insolvency, not upon bankruptcy); *Willren's Fuel Dist., Inc. v. Noreen*, 882 P.2d 399 (Alaska 1994) (same); *A.R. Teelers & Assoc., Inc. v. Eastman Kodak Co.*, 836 P.2d 1034 (Ariz. 1992) (same applying Arizona law).

If the common law imposes a trust relationship, that relationship must exist with reference to a res. In this context, the res is the assets of the corporation which constitute a trust fund for the creditors, and the officers and directors are the trustees, whether or not they are ready, willing or able. The duty of the trustees is to manage the assets of the insolvent corporation for the benefit of the creditors, not for the stockholders and certainly not for themselves. *In re Hospital General San Carlos, Inc.*, 76 B.R. 10 (D.C. Puerto Rico 1987); *Coleman v. Howe*, 154 Ill. 458, 467, 39 N.E. 725, 727 (1895) ("It is the duty of the directors of a corporation to manage its capital stock as a trust fund for the benefit of its stockholders while it exists and of its creditors in case of its dissolution."); but see Section 2(a)(v), infra (describing how boards of corporations in the "vicinity of insolvency" owe an obligation to the corporate enterprise as a whole).

Practice Consideration: Courts in the United States have recognized that the fiduciary obligations of directors "switch" from a duty owed to shareholders to a duty owed to creditors when the entity is insolvent or in the shadow of insolvency. This means that the first allegiance of directors of an insolvent entity must be to creditors and that creditors may bring an action against the directors for breach of fiduciary duty.

(iii) The Business Judgement Rule.

A majority of jurisdictions, including Delaware, provide corporate directors with a safe harbour known as the business judgement rule, which insulates them from liability in connection with certain business decisions. *See In re Xonics*, 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989). The business judgement rule is a presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority. *See* Black's Law Dictionary, 192 (7th ed. 1999); *See also Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984). Under a business judgement analysis, although directors of an insolvent corporation owe fiduciary duties to its creditors, they may continue to take ordinary operational risks in trying to save the company through methods they reasonably believe have a good chance of success. *See Paramount Communications, Inc. v. Time, Inc.,* 571 A.2d 1140 (Del. 1989). The application of the business judgement rule shields disinterested directors from liability, in the absence of fraud or illegality, for those business decisions made in good faith for the benefit of the corporation.

Practice Consideration: The business judgement rule, applied by a majority of jurisdictions, is the most important legal protection available to the directors of a business entity when their decisions are challenged by those who have been harmed by the consequences of those decisions. To avail themselves of the business judgement rule, directors must:

- **Inform themselves with respect to the matter for determination by studying and relying upon information that a reasonable person in similar circumstances would find persuasive; and**

- **The directors must be free from a conflict of interest with respect to the matter for decision.**

FDIC v. Sea Pines Co., 692 F.2d 973 (4th Cir. 1982) illustrates conduct by directors which is not shielded by the business judgement rule. In *FDIC v. Sea Pines Co.,* a parent corporation and subsidiary had interlocking Boards of Directors. Upon the insolvency of the subsidiary, the court found that the directors of the subsidiary breached their fiduciary duty to creditors of the subsidiary, including a failed financial institution, through a series of intercorporate transactions. The court then imposed liability upon the parent corporation based upon the breach of fiduciary duty owed to creditors by the subsidiary and the substantial overlap in the make-up of the two boards of directors. The directors were not shielded by the business judgement rule in this case because the intercorporate transactions were not made in good faith or for the benefit of the subsidiary. The directors were trying to avoid paying the creditors of the subsidiary by transferring its assets to the parent. This type of self-dealing, bad faith transaction violates the duty directors of insolvent corporations owe creditors, and results in the directors being held personally liable for the debts of the corporation.

(iv) *The New York Rule.* New York adheres to a minority rule: the strict application of the Trust Fund Doctrine. In *New York Credit Men's Adjustment Bureau, Inc. v. Weiss,* 110 N.E. 2d 397 (N.Y. 1953), the governing case in New York, the trustee in bankruptcy sued two directors of a bankrupt company seeking to impose personal liability on the directors for failure to obtain maximum value in selling the insolvent corporation's assets. *See id.* at 399. The action was based upon a New York statute which permitted the suit to be brought against directors for neglect or failure to perform their duties. *See id.* at 397. The defendant directors, after cutting expenses, determined that they were unable to continue their business, so they decided to liquidate the corporation's assets at public auction, which only netted about one third of value of the assets. *See id.* at 398. Despite a complete lack of evidence indicating fraud or insider benefit by the directors, the court held that the case should not be dismissed and noted that if the corporation was insolvent at the time of the alleged breach of fiduciary duty, "it is clear that [the] defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor-beneficiaries." *Id.* Since the assets could have been sold for more money, the directors could be held liable for the difference, regardless of their good faith or motive in the transaction. This standard would apply even if the corporation was solvent, if insolvency was imminent. *See id.*[1]

Strict application of the trust fund doctrine fully protects creditors of an insolvent corporation but, the doctrine may make people reluctant to become directors for fear of personal liability. As a result, only a minority of jurisdictions have adopted strict adherence to the trust fund doctrine.

(v) The "At Risk" Transaction. In *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 1991 WL 277613 (Del.Ch. December 30 1991) the directors were sued by a shareholder holding 98% of the company's stock for breach of fiduciary duty *to the shareholder*. The corporation, MGM post leveraged buyout, was operating "in the vicinity of insolvency". The shareholder complained that the directors had failed to approve a sale of assets which the shareholder sought because the proceeds of the sale would have paid down bank debt and returned control of the company from the bank to the shareholder. The directors refused to authorize the sale because they suspected that the sale price was too low and that the shareholder was principally concerned with paying down bank debt to regain control and not maximizing the value of the company's assets. In ruling that the directors had not breached their duty to the shareholder, the Chancellor stated:

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. . . . [T]he MGM board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgement in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity. *Id.* at *34.

The Chancery Court noted that the "possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behaviour, and creating complexities for directors. *Id* at fn 55. The *Credit Lyonnais* court then went on to provide an intriguing example of the conflicting demands upon a director of a corporation operating in the shadow of insolvency. In the court's example, assume that the sole asset of a corporation is a legal claim for 51 million dollars, with a one in four chance of success. Assume further

[1] In Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506 (2d Cir. 1981), cert. denied, 455 U.S. 990 (1981), a Canadian receiver brought suit against individual directors who approved and participated in loans made by the insolvent corporation to affiliated corporations. Among other things, the directors approved the conversion of the loans from demand instruments to term obligations with no payments due until maturity ten years hence. On appeal, the Second Circuit confirmed that the directors owed a fiduciary duty to creditors that could be enforced by the receiver. The jury verdict affirmed for the most part on appeal, amounted to thirty million dollars apportioned among the directors.

that the only creditors of the company are bondholders with a 12 million dollar claim. At what dollar amount should the directors settle the legal claim, assuming they have the opportunity to do so? The creditors want to get out at 12 million. The shareholders want more, but their risk taking jeopardizes the rights of creditors. The court stated:

> [I]f we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than [the value of the claim divided by the probability of success] and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act. *[Id.]*

The court concluded that the directors had not breached duties owed to the 98% shareholder in refusing to authorize a sale of assets at fire sale prices. The director's duty, in the shadow of insolvency, is owed to the entity, not merely to a single constituency.

In *re Ben Franklin Retail Stores, Inc.,* No. 97C7934, 97C6043, 2000 WL 28266 (N.D. Ill. Jan. 12, 2000), the officers and directors of the insolvent corporation were accused of overvaluing their receivables to induce creditors to lend the corporation money. *See id.* at *2. The creditors were harmed because the corporation sank deeper into insolvency as its liabilities grew. *See id.* Applying Delaware law, the Illinois District Court held that directors do not owe a duty to liquidate and pay their creditors when the corporation is near insolvency, provided the directors have a good faith belief that an alternative exists to maximize the corporation's long term wealth. *See id.* at *4. The court cited *Credit Lyonnais* for the principle that when a corporation is operating in the vicinity of insolvency, directors owe a duty to the corporate enterprise, not just the creditors or the shareholders. *See id.* This case indicates that directors cannot be held liable by creditors when a corporation is operating in the vicinity of insolvency absent self-dealing, bad faith or fraud. The court rejected a strict application of the trust fund doctrine and upheld the business judgement rule for directors in the context of insolvency.

It is significant to note that neither the *Credit Lyonnais* case nor its progeny have enunciated any guidelines for when a corporation enters into the "vicinity of insolvency." *See* Gregory Scott Crespi, 55 S.M.U. L. Rev. 141, 153 n. 33 (2002) (canvassing various law review articles commenting on the ambiguity and difficulty of applying the "vicinity of insolvency" test). Attorneys advising corporate boards should be aware of this uncertainty and advise their clients accordingly.

Practice Consideration: Generally, there is no equivalent liability in the United States for what is referred to as wrongful trading in Great Britain and other jurisdictions. Officers and Directors of an insolvent business entity, however, must carefully examine the totality of the circumstances surrounding the continued incurrence of trade debt to analyze whether the directors will be able to avail themselves of the business judgement rule if they should choose to allow the company to continue to operate. Directors should ask themselves what the likelihood is of a successful turnaround that will enable the company to meet its obligations. Directors should be certain that they are acting reasonably with respect to any financial analyses on which they are relying and they must analyze whether their decision is tainted by a conflict of interest.

Practice Consideration: One reason for the popularity of reorganization proceedings under chapter 11 of the Bankruptcy Code is that the Bankruptcy Court must approve, after notice and hearing, any transaction outside of the ordinary course of business for the debtor entity. See 11 U.S.C. sec. 363. Court approval, following notice to creditors and hearing, ought to insulate corporate directors from liability with respect to the proposed transaction, provided that the transaction and its consequences have been accurately disclosed in the court filings.

Practice Consideration: Another reason for the popularity of reorganization proceedings under chapter 11 of the Bankruptcy Code is the reduction or the removal of the risk that the continued accrual of unpaid trade debt will result in liability to the directors of the entity. Upon filing, the debtor is prohibited in most circumstances for paying any pre-filing unsecured debt other than by means of a Plan of Reorganization. The freeze on paying existing trade debt inevitably creates a cash flow benefit that should enable the debtor to meet its current obligations, at least for a time. Continued failure to pay trade debt following a chapter 11 filing, however, is not permitted and can lead to various consequences, including conversion to chapter 7.

(vi) Another Example: *In re Healthco Intern., Inc.*, 208 B.R. 288 (Bankr. D. Mass. 1997). Healthco involved a business failure following a leveraged buyout. Applying Delaware law, the Bankruptcy Court ruled as follows:

- The bankruptcy trustee has standing to bring a breach of fiduciary duty claim against the directors of the failed company, because the duty is owed to the debtor and breach of that duty is a claim of the debtor. *Id* at 300.[2]

- When a transaction renders a corporation insolvent or brings it to the brink of insolvency, “the rights of creditors become paramount”.” *Id.*

[2] In a Chapter 7 or straight liquidation proceeding, a trustee is appointed to assemble and liquidate the debtor's assets. In a Chapter 11 or reorganization proceeding, although a trustee can be appointed for cause, the debtor ordinarily retains possession and control of its assets. The debtor-in-possession has the powers of a trustee and is a fiduciary of the bankruptcy estate. The trustee or debtor-in-possession controls the administration of the bankruptcy estate during the proceeding.

- A duty to both shareholders and creditors is not irreconcilable. The duties are incident to the duties of directors to the corporation. "A distribution to stockholders which renders the corporation insolvent or leaves it with unreasonably small capital, threatens the very existence of the corporation. This is prejudicial to all constituencies, including creditors, employees and stockholders retaining an ownership interest." *Id*.

- Unreasonably small capital, within the meaning of the fraudulent transfer statutes, means a condition in which insolvency, in the liquidity sense, is reasonably foreseeable. *Id* at 302.

- Under Delaware law, the business judgement rule essentially requires a showing of gross negligence before a director can incur liability for her business decision. Several of the Healthco directors, however, could not rely upon the business judgement rule, because they had a material financial interest in the outcome of the transaction on which they voted. Instead, those directors had the burden of proving that their actions did not render the corporation insolvent or with unreasonably small capital.

- An additional prerequisite to a defence based on the business judgement rule is that the director has adequately informed herself with respect to the matter under consideration. Two Healthco directors, who may not have had a material interest in the outcome of the LBO, nonetheless cannot avail themselves of the business judgement rule because they failed to adequately inform themselves before voting on the transaction. The directors did not even review financial projections with respect to the post buy-out enterprise.

- Advisors and investment bankers risk liability for aiding and abetting a breach of fiduciary duty by directors.

B. Director Liability under the Uniform Fraudulent Transfers Act.

The Uniform Fraudulent Transfer Act has been enacted in 43 jurisdictions, with some local variation. UFTA governs those circumstances under which the transfer of property or the incurrence of an obligation by an insolvent entity may be avoided by creditors of the entity. Generally, the officers and directors of an insolvent entity risk liability under UFTA only if they are the transferee of the property of the insolvent entity. However, the directors of an insolvent entity risk liability for breach of their fiduciary duties to creditors (or to the company) if they vote for or permit the insolvent entity to engage in or undertake a fraudulent transfer.

Transfers Avoidable by Existing Creditors. Under UFTA, a transfer of property or the incurrence of an obligation is avoidable by existing creditors of the entity if the transfer was made or the obligation incurred for less than reasonably equivalent value and the debtor was insolvent at the time of the transfer or incurrence of the obligation or was rendered insolvent thereby.

Transfers Avoidable by Existing and Future Creditors. Under UFTA, a transfer of property or the incurrence of an obligation is avoidable by existing and future creditors of the entity if:

(i) The transfer was made or the obligation incurred with actual intent to hinder, delay or defraud creditors; or

(ii) The transfer was made without receiving reasonably equivalent value and the debtor:

(a) was engaged or was about to engage in a business or a transaction for which the remaining assets of the entity were unreasonably small in relation to the business activity to be undertaken; or

(b) intended to incur or reasonably should have believed that it would incur debts beyond its ability to pay as those debts came due.

Practice Consideration: A majority of the breach of fiduciary duty claims against directors of an insolvent entity relate to the director's authorization of a transaction that is challenged as a fraudulent transfer. These challenged transfers generally take one of two forms:

(i) The transfer of property from the insolvent entity to a corporate parent, either in the form of the outright conveyance of tangible or intangible property or in the form of a dividend; and

(ii) The incurrence of a debt by the insolvent entity where the entity receives little or no value on account of the obligation. The classic examples include:

a. The guaranty of the obligations of the parent or an affiliate; and

b. The incurrence of debt in the context of a "leveraged buy out". In a leveraged buyout, the entity incurs debt and encumbers its assets to enable the acquirer to buy the stock of the selling shareholders.

Directors asked to approve any of the foregoing transactions should be aware that they risk liability to existing and future unpaid creditors of the insolvent entity.

C. Director Liability for Unlawful Dividends and Redemptions.

Each state's corporation's law specifies the circumstances under which the corporation can redeem its outstanding shares or issue and pay dividends. Likewise, each state's corporations law set forth the penalties that may be imposed on directors that authorize a dividend or a redemption in violation of the applicable standards.

Under Delaware law, directors have liability for the wilful or negligent violation of the applicable provisions of Delaware's corporation's law governing the redemption of stock or the issuance of dividends. In either case, the directors are each jointly and severally liable to the corporation and its creditors for the full amount paid out in dividends or on account of the redemption.

Delaware law provides that a corporation may not redeem outstanding shares when its capital is impaired or would be impaired by the redemption. This means that the corporation may only use capital surplus to effect a redemption. Capital surplus may generally be thought of as the amount by which the total assets of the company exceed its total liabilities. If a promissory note or other debt instrument is given as payment for a redemption, the legality of the redemption is determined at the time the debt instrument is delivered, not at the time it is payable. Delaware law provides generally that dividends also may only be paid from surplus or from net profits of the current or preceding year.

Directors of Delaware corporations should value assets on a current basis to determine if surplus exists to pay a dividend or redeem stock. Directors acting in good faith and subject to a standard of reasonableness are entitled to rely upon reports, appraisals and other information provided to the corporation in determining the value of the corporation's assets.

The issue of what constitutes a "dividend" is another important consideration. Whether a distribution by a corporation to shareholders constitutes a "dividend" is not controlled by how that distribution is denominated. See generally Fletcher Cyc. Corp. § 5381 (permanent ed.) ("The characterization of a distribution, while relevant to the determination of whether or not it will be treated as a dividend, is not conclusive."). Rather, courts generally examine the substance of a transaction, rather than its nominal form, in assessing how to properly characterize a given distribution, and will recharacterize improperly styled transactions as being "constructive dividends." See Rogers v. United States, 58 F.Supp. 2d 1235, 1240-42 (D. Kan. 1999) (tax case discussing the ability of a court to recharacterize a transaction as being a constructive dividend); United States v. Mews, 923 F.2d 67, 68 (7th Cir. 1991) ("By 'constructive dividend' the law means simply a corporate disbursement that is a dividend in the contemplation of law though not called such by the corporation making the disbursement."). Intercorporate transfers which are neither loans, purchases, repayments of corporate debt, charitable expenditures, ordinary and necessary business expenses, or other disbursements made in pursuit of corporate goals or pursuant to corporate duties will, necessarily, be deemed "dividends" by a reviewing court. Mews, 923 F.2d at 68.

Constructive dividends can give rise to director liability. In In re: Buckhead America Corp., 178 B.R. 956 (Bankr. D. Del. 1994), the court addressed the question of whether liability under Section 174 of the Delaware General Corporation Law could be properly predicated on an allegedly improper constructive dividend. In rejecting the defendant's motion to dismiss, the Court noted, *inter alia*, that the factual record was insufficiently developed to warrant dismissal at that juncture of the proceeding. Thus, the court, at least implicitly, embraced the notion that a claim under section 174 could, in appropriate circumstances, be based on an allegedly improper constructive dividend. See also Crowters McCall Pattern, Inc. v. Lewis, 129 B.R. 992 (Bankr. S.D.N.Y. 1991) ("If plaintiff's allegations [regarding constructive improper dividend] are true, as must be assumed on these motions to dismiss, the economic substance of the transactions in question brings them within the purview of the relevant sections of the Delaware General Corporation Law.").

Practice Consideration: A dividend by an insolvent or struggling business entity is an obvious suspect and directors who vote for such a dividend may incur personal liability in the amount of the dividend. Counsel must review the relevant State corporation law to study the standards that must be met before the entity may legally make a distribution to its owners.

Counsel should also look for any safe harbours that may exist under the State corporation law with respect to actions based upon financial statements prepared by the auditors of the business.

Practice Consideration: Counsel must determine whether it is sufficient for a director to merely abstain from a vote in order to avoid liability or if the director must affirmatively vote against the proposed dividend to avoid liability. The result will differ depending upon the jurisdiction of incorporation. *See Calkins v. Wire Hardware Co.*, 257 Mass. 52, 165 N.E. 889 (1929) (although shareholder directors of a corporation did not vote in favour of a dividend, they are found liable as directors for assenting to an unlawful distribution where they actually received the proceeds of the distribution).

D. Liability for "Trust Fund" Taxes.

Under 26 U.S.C..A. § 6672(a), any person required to collect, account for, and pay over any federal tax who wilfully fails to do so, or wilfully attempts to evade the tax, is liable for the entire amount of the trust fund tax owed. This liability is in addition to other penalties provided by law. See 26 U.S.C. § 6672(a). Liability may be assessed against more than one person, and each person is liable for the entire amount of unpaid tax. See Harrington v. U.S., 504 F.2d 1306, 1312 (1st Cir. 1974); Gardoury v. U.S., 187 B.R. 816, 823 (D.R.I. 1995); In re Bourque, 153 B.R. 87, 92 (Bankr.D.Mass. 1993). Each person liable under § 6672 enjoys a right of contribution against other liable persons, but an action to recover the excess of one proportion may not be joined or consolidated with federal § 6672 actions or counterclaims. See 26 U.S.C.A. § 6672(d).

For purposes of § 6672, a "person" is defined statutorily to include not only the taxpaying entity itself, but also "an officer or employee of a corporation, or member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." 26 U.S.C.A. 6671(b). Statutorily exempt from § 6672(a) are unpaid, volunteer trustees or directors of tax exempt organizations who serve solely in an honorary capacity, do not participate in the organization's day-to-day or financial operations, and lack actual knowledge of the failure to account for the taxes, *unless* this exemption would result in no person being liable for the penalty. See 26 U.S.C.A. § 6672(e).

However, the definition of "responsible person" for purposes of § 6672 is limited neither to the statutory enumeration nor to persons performing the "mechanical functions of collection and payment." Harrington, 504 F.2d at 1312 (citations omitted). Rather, it extends broadly to persons with authority and responsibility to avoid the default. See id. The First Circuit has indicated that factual "[i]ndicia of responsibility include the holding of corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees." Thomsen v. U.S., 887 F.2d 12, 16 (1st Cir. 1989) (citing George v. U.S., 819 F.2d 1008, 1011 (11th Cir. 1987)). Courts look to "whether the person had the power to determine whether the taxes should be remitted or paid or had 'final word as to what bills should or should not be paid and when.'" Caterino v. U.S., 794 F.2d 1, 5 (1st Cir. 1986) (quoting Adams v. U.S., 504 F.2d 73, 75 (7th Cir. 1974)). Delegation to other officers or employees of tax compliance duties is no defence against liability. See Thomsen, 887 F.2d at 16.

An outside entity may be deemed a responsible person if the entity exerts sufficient control over the financial affairs of the delinquent taxpayer. See, e.g., Merchants Nat'l Bank of Mobile v. U.S., 878 F.2d 1382 (11th Cir. 1989) (bank exercised almost complete control over corporate taxpayer); Sokaogon Chippewa Community Tribal Council v. U.S., 959 F.Supp. 1032 (E.D.Wis. 1997) (tribe owned business and council oversaw hiring and certain financial transactions).

The federal "trust fund taxes" to which § 6672 applies are all funds collected by the taxpayer from third parties and deemed a special fund in trust for the United States pursuant to 26 U.S.C.A. § 7501. See Harrington, 504 F.2d at 1311. These most prominently include withheld employee social security taxes (see Harrington, 504 F.2d at 1311 n.2.) and withheld employee income taxes (see Thomsen, 887 F.2d at 14), but also include federal excise taxes (see 26 U.S.C.A. §§ 4001-4682) and collections on gambling winnings (see 26 U.S.C.A. § 3402(g)), interest and dividend payments subject to backup withholding (see 26 U.S.C.A. § 3402(q)), distribution from retirement plans (see 26 U.S.C.A. § 3405(e)), payments of interest and dividends to nonresidentnon-resident aliens and foreign corporations (see 26 U.S.C.A. §§ 1441-42), and disposition of United States real property interest by foreign persons (see 26 U.S.C.A. § 1445).

IRS policy permits the taxpayer to designate its tax payments first toward trust fund taxes, in order to eliminate personal liability, where such payments are "voluntary." See In re Energy Resources Co., Inc. 871 F.2d 223 (1st Cir. 1989) affirmed 110 S. Ct. 2139 (1990); In re Kaplan, 104 F.3d 589, 596 n.16 (3rd Cir. 1997). The IRS traditionally considers payment involuntary where it results from a distraint, levy, or legal proceeding in which the U.S. seeks to collect delinquent taxes. See Energy Resources, 871 F.2d at 228 (citations omitted). Where the taxpayer fails specifically to designate allocation of the voluntary payment, the IRS may allocate it. See Sotir v. U.S., 978 F.2d 29 (1st Cir. 1992). However, where there would have been no recovery of tax funds at all if not for the debtor corporation's efforts to collect funds owed it by a third party, the court may grant equitable recognition of the debtor's efforts by directing the IRS to allocate the collected funds toward trust fund obligations. See New Terminal Stevedoring, Inc. v. M/V Belnor, 728 F.Supp. 62 (D.Mass. 1989).

Regardless of whether the payments are voluntary or involuntary, the Supreme Court has held that a bankruptcy court has the authority in a Chapter 11 reorganization to order the IRS to allocate the payments first toward trust fund taxes, if the court deems such designation "necessary for a reorganization's success." Energy Resources, 495 U.S. at 551. Although the Court neither provided guidelines as to how to determine whether the allocation is "necessary" nor required bankruptcy courts to make specific findings on the question, courts have weighed the importance of the allocation to the responsible person's incentives and ability to pursue the reorganization. See, e.g. In re Oyster Bar of Pensacola, Inc., 201 B.R. 567 (Bankr. N.D.Fla. 1996) (argument that debtor's allocation would increase incentive of responsible person to participate in reorganization was insufficient evidence to warrant finding of necessity); U.S. v. R.L. Himes & Assoc., Inc., 152 B.R. 198, 200-01 (S.D. Ohio 1993) (upholding bankruptcy court finding of necessity where debtor's principal testified that corporate officers' incentive to pursue successful reorganization would be greatly diminished if they remained liable for trust fund taxes); In re. M.C. Tooling Consultants, Inc., 165 B.R. 590 (BkrtcyD.S.C.1993) (finding necessity where debtor's principal testified that he had been unable to concentrate on business operations due to IRS harassment over debtor's trust fund tax liability). Courts have split over whether a bankruptcy court may also direct allocation in a Chapter 11 liquidation plan. See e.g., In re Deer Park, Inc., 10 F.3d 1478 (9th Cir, 1993) (yes, where necessary to the success of the liquidation); In re Kare Kemical, Inc., 935 F.2d 243 (11th Cir. 1991) (no, since there is no "reorganization" for which the allocation is necessary).

Practice Consideration: Responsible person liability for unpaid trust fund taxes should be avoided at all costs. The liability cannot be discharged even in a personal bankruptcy proceeding. The lesson is simple (but still routinely ignored): Do not borrow from the United States Internal Revenue Service!

E. Insider Preferences.

The law of preferences governs those circumstances where a creditor may have to repay money to a debtor or its estate or relinquish a lien on property of the debtor for the purpose of achieving a more equitable distribution of the debtor's property. There are two sources of preference law: the Bankruptcy Code and UFTA.

Insider Preferences Under the Bankruptcy Code. Under the Bankruptcy Code, a transfer of the debtor's property on account of an antecedent debt made to an insider while insolvent and within one year of an order for relief under the Bankruptcy Code is recoverable by the trustee of the debtor for the benefit of the debtor's estate. See 11 U.S.C. sec. 547. The definition of insider is found at 11 U.S.C. sec. 101(31) and includes, with respect to corporations, an officer, director, person in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, and a relative of any of the foregoing. An avoidable preference may exist in the context of the payment of a debt and it may exist if the debtor secures an otherwise unsecured or under-secured debt within the relevant preference period. The preference period for non-insider transferees is ninety (90) days. A debtor is presumed to be insolvent during that 90-day period. For claims against insiders, however, the Trustee must prove that the debtor was insolvent during the period preceding the non-insider 90-day preference period.

Practice Consideration: Under the Bankruptcy Code, a preference exists only if the creditor receives more than it would receive in a hypothetical liquidation of the debtor under chapter 7 of the Bankruptcy Code. Due to this requirement, a properly perfected secured creditor of the debtor whose collateral equals or exceeds in value the amount of its claim cannot receive a preference under the Bankruptcy Code. For this reason, among others, it pays to obtain security for any obligation, including the debt of a corporate subsidiary, and to perfect that security in accordance with all applicable legal requirements.

Insider Preferences under State Law. UFTA provides that a transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt at the time the debtor was insolvent and the insider had "reasonable cause" to believe that the debtor was insolvent. UFTA claims are not limited by the one-year look back period that exists in the bankruptcy context. This means that a creditor of the debtor entity can recover the amount of the preference from the insider. As set forth in the Uniform Act, the statute of limitations for such a claim is six years, although practitioners should check each state's version of UFTA to confirm that the 6-year limitations period specified in the Uniform Act applies in that jurisdiction.

F. Director Liability Under Federal Securities Laws.

The Securities Act of 1933 (the "Securities Act").

The Securities Act governs the registration of a public offering of securities and the disclosures that must accompany that registration. Section 11 of the Securities Act imposes liability on the signers of a registration statement, the issuer's directors and certain other persons for any untrue statement of a material fact contained in the registration statement and for the failure to state a material fact in the statement. Section 11 allows the purchaser of the security to sue the issuer, the director and others.

The primary defence to Section 11 liability is due diligence. To establish that defence, the director must show that, after reasonable investigation, the director had reasonable grounds to believe, and did believe, that the registration statement did not contain any materially misleading statements or omissions.

Section 12(1) of the Securities Act imposes liability on the seller of an unregistered security that should be registered. A seller may include the officers and directors of the issuer. Section 12(2) of the Securities Act imposes liability on a person that offers to sell a security by means of an oral communication or a prospectus that contains material misstatements or that fails to contain material information.

Section 15 of the Securities Act imposes liability on a person that "controls" a person that violates sections 11 or 12 of the Act. Section 15 is yet another means by which an individual may incur liability for violations of the Securities Act of 1933. Section 17(a) of the Securities Act contains a prohibition against fraud in the offer or sale of securities.

Securities Exchange Act of 1934.

The Exchange Act contains a general antifraud provision at section 10(b) which, when combined with Rule 10b-5 promulgated by the Securities Exchange Commission, prohibits the employment of any device, scheme or artifice to defraud, the making of any untrue statement of material fact or the omission of material facts which are necessary to make a statement not misleading in connection with the purchase of sale of a security. Section 10(b) and Rule 10b-5 applies to any purchase or sale of a security that involves any means of interstate commerce, the use of the United States mails or a national exchange and is not limited to claims relating to the content of a registration statement or the failure to register an offering. Since 1946, federal courts have recognized a private right of action in favour of the purchaser or the seller of a security under Section 10(b) of the Exchange Act.

Merely negligent conduct by and officer or director will not give rise to liability under Section 10(b) of the Exchange Act. The United States Supreme Court has ruled that a plaintiff must prove by a preponderance of the evidence that the defendant acted with "*scienter*", a mental state that encompasses knowing or intentional deception, manipulation or fraud.

The Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act, Public Law No. 107-204, was adopted in 2002 with the intent of improving corporate accountability and transparency. It applies primarily to public companies registered under the Exchange Act of 1934, although certain provisions extend to non-public entities. Among other things, the Sarbanes-Oxley Act increases penalties for violations of securities laws and regulations, and may define or inform the duties owed by corporate officers and directors to corporations and corporate shareholders. For a good overview of the Sarbanes-Oxley Act's effect on corporate directors and officers, see Dan A. Bailey and J. David Washburn, *Now its Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers*, 6(4) Wall Street Lawyer 9 (2002).

G. Liability under Federal Environmental Laws.

The United States courts have been willing to impose personal liability on owners, officers or directors of corporations that have violated certain federal environmental laws. The most common laws posing the risk of personal liability are the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended by the Superfund Amendments and Reauthorization Act of 1986, commonly known as CERCLA. CERCLA provides responsibility and remedies for the disposal and cleanup of uncontrolled hazardous waste sites. One other regime that may result in personal liability is the Resource Conservation and Recovery Act (RCRA), which governs the handling, storage, treatment, transportation and disposal of solid waste, including hazardous waste. Many states have also adopted state-law counterparts to the Federal environmental statutes.

Owners, officers or directors risk personal liability under CERCLA or RCRA when they personally engage in the conduct of the business entity that violates the relevant statute. For example, if the officer directed the offending activities, that officer risks personal liability. Some courts have imposed personal liability on officers where the officers had authority over the disposal activities of the company, but did not exercise that authority and did not participate in the illegal conduct. In that instance, the officer has liability because the officer could have prevented the illegal conduct.

Practice Consideration: Any officer, director or owner that actively participates in conduct by a business entity that violates CERCLA, RCRA and other federal and state environmental laws risks personal civil and criminal liability. Enforcement authorities in the United States have not hesitated to seek to impose personal liability due to involvement in the violation of remedial environmental laws. The United States Department of Justice has a separate unit devoted exclusively to prosecuting criminal violations of the federal environmental laws. The risk of personal liability is undoubtedly greater where the business entity has failed, because the entity cannot practically ameliorate the harm or pay a fine.

Traditional arguments for disregarding the corporate form (veil piercing) have also been used to impose liability on individual officers, directors and owners of business entities.

H. Liability for Misappropriation of Corporate Opportunities.

Misappropriation of corporate opportunities is a special form of self-dealing that can result in individual liability to officers and directors. In *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966), the supreme court of Delaware stated the standards for when an opportunity must be presented to the corporation: When there is presented to a corporate officer a business opportunity which the corporation is financially able to undertake, and which, by its nature, falls into the line of the corporation's business and is of practical advantage to it, or is an opportunity in which the corporation has an actual or expectant interest, the officer is prohibited from permitting his self-interest to be brought into conflict with the corporation's interest and may not take the opportunity for himself.

Practice Consideration: Business entities in financial distress are seldom in a position to take advantage of a new business opportunity, but that will not prevent a representative of the failed company's creditors from seeking damages from an officer or director that misappropriates a corporate opportunity. An insider of a struggling business entity risks liability (or at least the cost of defending a suit) if his basis for appropriating a corporate opportunity is the financial ill health of the corporation that he serves.

QUESTION 3

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3. Other Persons Involved with the Debtor's Affairs that may have Liability In Respect to their Actions During the Twilight Period.

(a) In addition to the formally appointed directors of the company, can others be held liable in respect of the company's activities during the "twilight" period if the company were to become subject to a formal insolvency procedure?

(b) In respect of which acts may other persons be held liable and to what extent does the liability of third parties differ from that for directors identified in question 2 above.

Will liability be limited to that resulting from involvement with a particular transaction or more generally in relation to the overall loss suffered by creditors.

A. Lender Liability and Equitable Subordination.

Lender liability is the generic term used to describe those circumstances under which a lender to the debtor may incur liability on account of its conduct. Lender liability claims run the gamut, from breach of contract to slander. In the context of an insolvent business entity, a lender's risk is more specific: Equitable subordination due to misconduct. The Bankruptcy Court has the power under Code sec. 510 (c) to readjust the priorities of claims and therefore subordinate one claim to another due to misconduct by the creditor.

(i) Equitable Subordination of Non-Insider Claims. Lender's claims against an insolvent entity are not frequently subordinated. Those instances leading to subordination usually involve misconduct by the lender to the detriment of the debtor's unsecured creditors. Some courts have suggested that such misconduct must be tantamount or similar to fraud on the part of the lender. The classic example involves a situation where the debtor operates solely for the purpose of liquidating the secured creditor's collateral and the debtor fails to pay its trade debt during the period of liquidation.

Practice Consideration: Counsel for secured creditors are well advised to require that a liquidating debtor produce an operating budget which accounts for all operating expenses during the period of liquidation. The lender can then approve or disapprove the budget proposed by the debtor. A lender should not, however, prepare its own budget or exercise a "line item veto" over the debtor's budget. A lender should permit and and/or require that the debtor pay ordinary operating expenses during the period of liquidation.

Practice Consideration: Occasionally, creditors of a debtor find themselves on the Board of Directors of the debtor. This may happen when the creditors have swapped some or all of their claims for equity in the Debtor as part of a reorganization. Creditors in this situation wear two hats and are well advised to resign as a Director if the debtor is failing.

(ii) Equitable Subordination of Insider Claims. Insider creditors are especially prone to principles of equitable subordination because the insider has special knowledge of the debtor's circumstances, the insider may have control over the debtor and the insider may owe fiduciary obligations directly to the debtor's creditors.

Practice Consideration: Insider creditors risk preference liability if their claims are unsecured and subordination if they control the subsidiary and use that power to their advantage and to the detriment of the debtor's general unsecured creditors. If representatives of the insider creditor serve on the Board of Directors of the insolvent entity, they risk affirmative liability for breach of fiduciary duty if they put the interests of the insider creditor ahead of the interests of the Debtor.

B. Aiding and Abetting Liability.

As discussed in section 4 above, the directors of an insolvent entity risk liability for breach of fiduciary duty if they put their own interests or those of a corporate parent ahead of the interests of the debtor's creditors. Likewise, those who assist the directors, such as counsel, accountants and investment bankers, risk liability for aiding and abetting a breach of fiduciary duty.

C. Shareholder Liability: The Corporate Disregard Doctrine (Piercing the Corporate Veil).

The corporate disregard doctrine is alive and well, although “the legal standard for when it is proper to pierce the corporate veil is notably imprecise and fact intensive.” *Crane v. Green & Freedman Baking Co.*, 134 F.3d 17, 21 (1st Cir. 1998). Counsel to a failing business entity must be aware of the risk that unsatisfied creditors of the business entity may attempt to impose liability upon the individual or corporate owner(s) of the entity. All counsel should be aware of the factors courts evaluate in determining whether to impose entity liabilities upon owners of the entity. As corporate counsel we cannot control in detail the activities of our business clients, but we can counsel them as to what is high risk conduct and we can take steps to mitigate the risk that a business entity will be disregarded if it is unable to satisfy its obligations.

Courts generally look at the following factors in determining whether to impose liability on the owners of a business entity. Many of the factors have greater relevance depending upon whether the owner is an individual(s) or another business entity. The factors are as follows:

1. common ownership among the parent entity and the subsidiary or among affiliates;
2. pervasive control by the parent entity;
3. confused intermingling of business activity, assets or management among the parent and subsidiary or among the entity and its shareholder(s);
4. thin capitalization;
5. non-observance of corporate formalities;
6. absence of corporate records;
7. no payment of dividends;
8. insolvency at the time of the litigated transaction;
9. siphoning away of corporate assets by the dominant shareholders;
10. non-functioning of officers and directors;
11. use of the corporation for transactions of the dominant shareholders; and
12. use of the corporation in promoting fraud.

The language and role of fraud in cases addressing corporate veil piercing has created confusion. Recent cases, however, indicate that a finding of fraud is not necessary. Applying New York law, the Second Circuit Court of Appeals has ruled as follows: “Liability therefore may be predicated either upon a showing of fraud or upon complete control by the dominating corporation that leads to a wrong against third parties.” *Wm. Passalacqua Builders v. Resnick Developers*, 933 F2d 131, 138 (2nd Cir. 1991). The Maine Supreme Judicial Court recently ruled that the corporate veil may be pierced where (i) the shareholder misused the corporate form and (ii) “an unjust or inequitable result would occur if the court recognized the separate corporate existence.” *Johnson v. Exclusive Properties Unlimited*, 720 A.2d 568, 571 (Me. 1998).

Practice Consideration: The practice of establishing a new subsidiary or affiliate entity to undertake a new venture has many advantages. One of the most significant benefits is that if the subsidiary is failing, it can be closed and the parent will lose only its investment in the subsidiary enterprise, but will not ordinarily be liable for the obligations of the failed enterprise. Counsel must help their clients retain the benefits of parent / subsidiary relationship by, among other things, assuring that the separateness of the two entities is maintained by adherence to all applicable corporate formalities and by advising that the entities deal with one-another on an arm's length basis in all circumstances.

QUESTION 4

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4. Counterparties dealing with the Debtor during the Twilight Period.

(a) From the point of view of a counter-party dealing with the company during the twilight period, what are the potential heads of challenge which may lead to transactions with the company being set aside.

(b) What defences, if any, to the areas of vulnerability identified above will be available to a counter-party seeking to protect a transaction from being attacked?

a. Trade Creditors.

Trade creditors are well advised to do business on a cash-on-delivery only basis if they have reason to believe that they are selling to an insolvent entity. A C.O.D. transaction is never a preference under the Bankruptcy Code. UCC section 2-702 expressly authorizes a seller of goods to refuse delivery to an insolvent buyer other than upon cash payment.

b. Rights of Reclamation.

Goods sold to an insolvent entity may be reclaimed upon demand made within ten days after delivery of the goods pursuant to UCC section 2-702. A seller's right to reclamation is subject to the rights of a buyer in the ordinary course or other good faith purchaser. Most courts have ruled that the seller's right to reclamation is inferior to the rights of a lender with a "floating" lien on the Debtor's inventory.

Practice Consideration: A seller should always make demand for reclamation in writing. Even following a filing under the Bankruptcy Code by the buyer, a timely claim for reclamation gives the seller valuable rights in the buyer's bankruptcy proceeding.

c. A Purchaser of Assets Other Than in the Ordinary Course.

A purchaser of substantially all assets of an insolvent or failing enterprise must have several concerns:

(i) Can the Seller convey clear title to the assets?

(ii) Will the buyer have liability for any of the Seller's obligations, such as trade debt, tax liabilities, employment-related liabilities or warranty or tort liabilities?

(iii) If the buyer strikes too good a deal, might the transaction be avoided as a fraudulent conveyance?

Practice Consideration: Buyer's of the assets of a failing enterprise often require that the Seller file under chapter 11 of the Bankruptcy Code so that the transaction can be consummated in the Bankruptcy Court. Although this procedure results in higher transactional costs, the buyer is far safer with an order of the Bankruptcy Court conveying the assets of the seller to the buyer free and clear of liens, claims and encumbrances, because the transfer will not be susceptible to subsequent avoidance by the bankruptcy trustee.

QUESTION 5

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5. Enforcement

By whom may action be brought against directors (and/or others identified in Question 3 above) and before which Courts?

Enforcement actions may involve civil or criminal proceedings and may be based upon Federal or state law or both. For example, criminal penalties exist for certain violations of the Federal environmental and securities laws. Most enforcement actions under these laws, however, is civil. Civil remedies may involve a judgment for damages, injunctive relief or both. Liability for breach of fiduciary duty, fraudulent transfers, unlawful dividends and redemptions and misappropriation of corporate opportunities is civil and may be enforced by the creditors of the insolvent entity, by its shareholders in certain instances and by a bankruptcy trustee of the insolvent entity. The specific rules of liability and enforcement will depend upon the applicable state law. Liability for failure to pay "trust fund" taxes is enforced by the respective taxing entity. Rights of enforcement are discussed in more detail in section 6 (Remedies; order available to the domestic court) immediately below

QUESTION 6

6. Remedies; orders available to the domestic court.

In respect of the offences identified in questions 2, 3 and 4 above, what remedies are available in the domestic court?

(a) Breach of Fiduciary Duty. Persons damaged due to a director's breach of fiduciary duty are entitled to a money judgment against the defendant in the amount of their damages.

(b) Fraudulent Conveyance under UFTA. The remedies available to creditors who demonstrate that the debtor has engaged in a fraudulent transfer are as follows:

(i) Avoidance of the transfer (return of the property);

(ii) Attachment of the property transferred;

(iii) Execution on the asset transferred, if the creditor already has a judgment;

(iv) Injunction against further disposition of property by the debtor;

(v) Appointment of a receiver to take control of the property transferred;

and

(vi) Damages in an amount up to two times the value of the property transferred.

(c) Unlawful Dividends or Redemptions. Under Delaware law, the directors who vote for an unlawful dividend or redemption face joint and several personal liability for the amount unlawfully distributed by the corporation.

(d) Trust Fund Taxes. A responsible person is liable for the full amount of trust fund taxes that the corporation fails to remit to the Internal Revenue Service.

(e) Receipt of a Preference. A person that receives a voidable preference is liable to repay the amount received. The liability of a recipient of a preference is reduced to the extent that the recipient has provided new value to the debtor following receipt of the preference, provided that the recipient has not received a preferential transfer on account of such new value.

(f) Misappropriation of Corporate Opportunities. Misappropriation of corporate opportunities is an action sounding in tort. A defendant may be liable for all damages proximately caused by the tortious conduct.

(g) **Indemnification of Officers and Directors.**

A corporation may elect to include in its by-laws permissive or mandatory indemnification of its officers and directors. Counsel must review the specific state corporation law with respect to indemnification, because the authority of the corporation to indemnify, and the scope of the potential indemnity, varies among jurisdictions.

The authority of a Delaware corporation to indemnify its officers and directors is found at Del. Code Ann. tit. 8, sec. 145. Section 145 authorizes indemnification against expenses, including attorney's fees, judgments, fines and amounts paid in settlement actually and reasonably incurred “if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful.”

Practice Consideration: Mandatory indemnification should probably be limited to directors and officers of the corporation, and not extended to employees and other agents. The by-law provision should also separately mandate the advancement of expenses, because Delaware courts have ruled that mere indemnification does not require the advancement of expenses.

(h) **Involuntary Proceedings under the Bankruptcy Code.**

Unsecured creditors of an insolvent business entity sometimes resort to the commencement of an involuntary proceeding under the Bankruptcy Code against the debtor. If the debtor has fewer than 12 unsecured creditors, one or more unsecured creditors with claims aggregating $10,775 may commence an involuntary petition against the debtor. If the debtor has twelve or more creditors, three or more unsecured creditors whose claims aggregate $10,775 may commence the involuntary proceeding. Claims that are in bona fide dispute are not eligible as petitioning claims. 11 U.S.C. sec. 303.

Unsecured creditors are most likely to commence an involuntary petition in those circumstances where they suspect that the debtor has been engaged in fraudulent conveyances or other misconduct.

The Bankruptcy Court will enter an order for relief under the Bankruptcy Code if it finds that the debtor is not generally paying its debts when they come due, unless such debts are in bona fide dispute. 11 U.S.C. sec. 303(h).

An involuntary petition may be filed against a debtor under chapter 7 or chapter 11 of the Bankruptcy Code. Chapter 7 is a straight liquidation where a trustee is appointed to assemble and liquidate the debtor’s property. Chapter 11 is discussed in the following section of the materials.

A “foreign representative” may commence an action ancillary to a “foreign proceeding” for the purpose of administering assets located in the United States pursuant to Bankruptcy Code section 304.

Practice Consideration. A foreign corporation may be a debtor under chapter 7 or chapter 11 of the Bankruptcy Code if it has a place of business in the United States or if it has property in the United States.

Practice Consideration. A debtor has the absolute right to convert an involuntary case under Chapter 7 of the Bankruptcy Code to a case under Chapter 11 of the Bankruptcy Code.

QUESTION 7

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7. Duty to Cooperate.

(a) To what extent are directors (and others identified in question 3 above) obliged to co-operate with an investigation into the company's affairs following its insolvency?

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any obligations (e.g., in the UK and other European jurisdictions Article 6 of the European Convention on Human Rights may apply if domestic law compels a person to provide potentially self-incriminating information at the request of the office-holder appointed under the relevant insolvency procedure adopted)?

(a) In the Bankruptcy Court.

Schedules. Bankruptcy Code section 521(1) requires that the debtor file a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures and a statement of the debtor's financial affairs. Official forms are prescribed for each of these filings. Absent a court order extending the deadline, the filings must be made within fifteen days of the order for relief under the Bankruptcy Code. In the case of a filing involving a corporation, the Court may order the appropriate corporate officers, directors, or other persons in control of the corporation to complete the schedules. Fed. R. Bankr. P. 9001(5).

Cooperation. Bankruptcy Code section 521(3) requires that the debtor cooperate with any trustee to enable the trustee to discharge his duties under the Bankruptcy Code. In a liquidation case, that cooperation will ordinarily relate to informing the trustee of and assisting in locating property of the estate in the possession of third parties. Cooperation may also involve assisting the trustee in evaluating claims against the debtor or claims in favour of the debtor. If the debtor is an entity, the duty to cooperate may be compelled from a corporate officer. Matter of Ron San Realty, Inc., 457 F. Supp. 994 (S.D.N.Y. 1978).

Turnover. Bankruptcy Code section 521(4) requires that the debtor surrender to the trustee all property of the estate and any recorded information, including books, documents, records, and papers related to property of the estate.

Practice Consideration. The knowing failure to disclose property of the debtor to the trustee or the knowing withholding of recorded information may constitute a crime under Title 18 of the United States Code.

Appearance. Bankruptcy Code section 343 requires that the debtor appear at an examination under oath conducted by the trustee (in a chapter 7 case) or by the United States Trustee (in a case under chapter 11). Creditors of the debtor are also entitled to attend the examination.

(b) Protection from Self-Incrimination.

Bankruptcy Code section 344 provides that immunity may be granted under Title 18 of the United States Code to persons required to submit to examination, to testify or to provide information in a bankruptcy case. Immunity granted pursuant to this section is intended to preserve an individual's right against self-incrimination as set forth in the 5th Amendment to the United States Constitution.

QUESTION 8

Appeals and Limitation periods

Please see question 6

QUESTION 9

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9. Foreign Corporations

Do the legal provisions and procedures outlined above apply to both domestic and foreign corporations?

A foreign corporation or other foreign business entity may be a debtor under the United States Bankruptcy Code if it has a place of business in the United States or if it has assets in the United States. Accordingly, a foreign corporation doing business in the United States may seek relief under chapter seven (liquidation) or chapter 11 (reorganization) of the Code and creditors of the entity may file an involuntary petition under the Code against the foreign entity. 11 U.S.C. sec. 109. Bankruptcy Courts in the United States have exercised jurisdiction over foreign debtors when the nexus with the United States was as little as a bank account or a clearing account.

Entities that are the subject of a foreign insolvency proceeding or their representative may also seek relief under the Code to administer assets in the United States. 11 U.S.C. sec. 304. Such relief may include issuance of an injunction to prevent creditors in the United States from executing on assets of the debtor located in the United States. In determining whether to exercise jurisdiction over the assets of a foreign debtor, the Bankruptcy Court considers the interests of creditors in a timely distribution of assets of the debtor, the convenience or difficulty in establishing claims against the debtor in the foreign proceeding, the prevention of preferences and fraudulent conveyances and the distribution priorities applicable under the foreign insolvency scheme.

A representative of a foreign entity undergoing insolvency proceedings in a foreign jurisdiction may also seek dismissal of a bankruptcy proceeding under the Code on the basis that the factors listed above (the interests of creditors in a timely distribution of assets of the debtor, the convenience or difficulty in establishing claims against the debtor in the foreign proceeding, the prevention of preferences and fraudulent conveyances and the distribution priorities applicable under the foreign insolvency scheme) weigh in favor of the single insolvency proceeding pending in the foreign jurisdiction. 11 U.S.C. sec. 305.

If the Bankruptcy Court asserts jurisdiction over a foreign debtor or its assets, the Court may permit the application of the Bankruptcy laws respecting the recovery of preferences, fraudulent conveyances and the turnover of the debtor's property. Application of these laws in the United States proceeding relating to a foreign debtor will likely depend on the size and sophistication of the United States creditor body, the status of a foreign insolvency proceeding, if any, and the substantive law that will apply in the foreign proceeding. If as a practical matter the ability of United Creditors to be paid depends upon the application of U.S. laws respecting preferences, fraudulent conveyances and/or turnover of estate property, the Bankruptcy Court is likely to allow application of these laws. In that event, officers and directors of foreign entities will be subject to the same substantive law that applies to officers and directors of domestic business entities. For this reason, officers and directors of foreign business entities should expect that unpaid creditors of the foreign entity in the United States will have access to the same rights and remedies against officers and directors as they would have against officers and directors of domestic business entities.

Officers and directors of foreign business entities doing business in the United States should also understand that state and federal laws regulating the affairs of businesses generally will apply to the foreign entity and to its officers and directors. Accordingly, state and federal laws with respect to environmental regulation and protection, anti-trust, employment, wage hour laws workplace safety, consumer protection, the issuance of securities and other laws will all apply with equal force to a foreign business engaged in commerce in the United States.

QUESTION 10

10. Insurance for Officers and Directors.

Is directors' and officers' insurance available in your jurisdiction? If so, to what extent will the availability of such insurance provide effective protection to directors against personal liability which may arise in connection with the issues raised in questions 1-9 above.

Most state corporations' statutes authorize the corporation to purchase insurance for its officers and directors. This is known as a D&O Policy. Insurance is very helpful, especially in those circumstances when the corporation is unable to satisfy its indemnification obligations due to insolvency.

A D&O Policy is an indemnity reimbursement policy. Typically, the carrier does not provide counsel and does not defend the claim. The carrier reimburses the insured at the conclusion of the action, up to the policy limits.

D&O policies are typically claims made policies, applying only to actions notice of which was given during the term of the policy.

Following notice of a claim, the issuer of a D&O policy will ordinarily issue a reservation of rights letter to protect itself. A reservation of rights is common in the context of a claim under a D&O policy and does not mean necessarily that the insurer will deny coverage.

Certain exclusions are standard in all D&O policies:

- nuclear accident*
- pollution and environmental liability*
- dishonesty
- personal profit
- unlawful remuneration
- other insurance
- claims noticed under a prior policy
- claims arising under ERISA and retirement, welfare and benefit plans*
- bodily injury and property damage*
- libel and slander*; and
- violation of § 16(b) of the Securities Exchange Act of 1934.

*These excluded risks are usually insured against under separate policies.

Litigation surrounding D&O policies focuses on the application for coverage, payment of interim defence costs and interpretation of the policy exclusions. Since the D&O policy is claims made, the insurer will require that the insured dictate all known claims and potential claims in the insurance application. If a claim later arises based on conduct prior to the date of the application, the insurer will likely deny coverage.

A policy application is ordinarily signed by the President of the company. Courts have held that innocent directors without knowledge of facts relating to a possible claim will nonetheless lose coverage if the corporation's President had knowledge of such a claim and failed to disclose it on the policy application. To protect against this eventuality, the company may purchase a policy with a severability provision. A policy with a severability provision means that the insurer takes a separate application from each insured officer and director and that the failure of any single officer or director to reveal facts pertaining to a potential claim will not void the coverage of an innocent insured.

QUESTION 11

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11. **How safe is it for directors and others to incur further credit during the twilight period?**

Chapter 11 of the United States Bankruptcy Code.

First, some levity. A businessman was in a great deal of trouble. His business was failing, he had put everything he had into the business, he owed everybody — it was so bad he was even contemplating suicide. As a last resort he went to a priest and poured out his story of tears and woe.

When he had finished, the priest said, "Here's what I want you to do: Put a beach chair and your Bible in your car and drive down to the beach. Take the beach chair and the Bible to the water's edge, sit down in the beach chair, and put the Bible in your lap. Open the Bible; the wind will rifle the pages, but finally the open Bible will come to rest on a page. Look down at the page and read the first thing you see. That will be your answer, which will tell you what to do."

A year later the businessman went back to the priest and brought his wife and children with him. The man was in a new custom-tailored suit, his wife in a mink coat, the children shining. The businessman pulled an envelope stuffed with money out of his pocket, gave it to the priest as a donation in thanks for his advice.

The priest recognized the benefactor, and was curious. "You did as I suggested?" he asked.

"Absolutely," replied the businessman.

"You went to the beach?"

"Absolutely."

“You sat in a beach chair with the Bible in your lap?”
“Absolutely.”
“You let the pages rifle until they stopped?”
“Absolutely.”
“And what were the first words you saw?”

“Chapter 11.”

(a) **Sources of Law; Introduction.**

The Bankruptcy Code is found at Title 11 United States Code. Chapter 11 refers to sections 1101, et seq. of Title 11. Chapter 11 contains the specific rules for business reorganization. However, the provisions of Chapters 1, 3, 5 and 7 apply to proceedings under Chapter 11.

Although the bankruptcy code is federal law, state law plays an important role in bankruptcy cases. The property interests of the Debtor and the interests of the Debtor’s secured creditors in the property of the Debtor are, for the most part, governed by state law. State law will provide the rule of decision with respect to numerous other issues that may arise in a reorganization proceeding.

The provisions of the Bankruptcy Code are interpreted and applied by the Judges of the United States Bankruptcy Court. Their published decisions and the respective appellate rulings comprise a sizable body of case-law to assist counsel.

This section of the materials is intended to provide only an overview of Chapter 11. The purpose is to assist counsel in understanding the circumstances where a filing under Chapter 11 may be a viable alternative for the client. Accordingly, these materials are not intended as an exhaustive analysis of the many detailed and complicated provisions of Title 11 that pertain to business reorganizations. Nor do these materials attempt to amass or collate the considerable case law that has developed with respect to practice and procedure under the Bankruptcy Code in general or Title 11 in particular.

The terms Debtor and Debtor in Possession are used interchangeably in these materials. Reference to the Code means Title 11 of the United States Code.

(b) **Who and What Can Seek Relief Under Chapter 11?**

Individuals and business entities can seek relief under chapter 11 of the Bankruptcy Code. Code sections 109(d) and 101(41). An entity must be properly authorized to file a petition by appropriate board, shareholder, member or partner action.

Practice Consideration: An individual should always consider eligibility under chapter 13, which relates to individual debt adjustment, before resolving on a filing under chapter 11.

Practice Consideration: An entity satisfying the eligibility requirements for filing under chapter 11 is not precluding from seeking such relief because it is a not-for-profit business entity.

Practice Consideration: The timing of a filing can matter a great deal. The Trustee or Debtor-in-possession can recover certain payments made by the Debtor on account of an existing debt to an unsecured or under-secured creditor made within ninety (90) days preceding the filing, or within one year with respect to insiders. Recovery of preferences can help fund a Plan of Reorganization, in appropriate cases. The threat of the recovery of preferences can help the Debtor negotiate more favourable Plan terms. The recovery of preferential payments is governed by 11 U.S.C. sections 547 and 550.

(c) **Why might a Business Entity file for relief under Chapter 11?**

- If a secured creditor is taking enforcement action to take possession of assets or to foreclose liens in real or personal property of the Debtor, the automatic stay imposed by Code sec. 362 will stop such action.

- If the Debtor is unable to pay its unsecured creditors in accordance with terms and creditors are commencing collection actions and/or seeking to attach assets, Code sec. 362 will force creditors to stop their collection actions.

- If the Debtor is facing costly litigation due to a product failure or warranty claims.

- If the Debtor wishes to consummate a going-concern sale of assets, but attachments or the threat of attachments makes the buyer unwilling or unable to close.

- If the Debtor needs working capital financing, but it's existing secured creditors will not make the loan and will not subordinate to new money.

- If the Debtor has a failing division and needs a venue within which to liquidate the division and restructure the financial obligations that arise out of the failure of the division.

(d) **Why File Under Chapter 11 Rather than Chapter 7 or Chapter 13**?

- Chapter 13 is only available to individuals and then only individuals whose secured and unsecured debts do not exceed a stated level. **See** Code sec. 109(e). Business entities may not use chapter 13.

- Chapter 7 results in the appointment of a trustee whose job is to liquidate the assets of the Debtor and distribute the proceeds in accordance with the priorities set forth in the Code. A chapter 7 trustee is not ordinarily interested in operating a business. If the goal is to maintain ongoing business operations, chapter 7 is probably not a viable option.

- Chapter 11 affords a business **an opportunity to restructure its debts** into a more feasible payment schedule.

- Chapter 11 affords a business **an opportunity to sell its assets in a setting superior to a foreclosure**.

- Absent special circumstances, a chapter 11 debtor remains in possession and control of its property. A chapter 11 debtor in possession and control of its property is known as a debtor-in-possession.

Practice Consideration: If the principals of the Debtor have engaged in serious pre-petition fraudulent conduct, on motion of a party in interest, the Court may appoint a trustee to take possession and control of the Debtor's business in the chapter 11 proceeding pursuant to Code section 1104. Counsel are well advised to inform their clients of this possibility. Counsel are also well advised to review the other grounds for appointment of a trustee set forth in Code section 1104 in a chapter 11 proceeding.

(e) **Examples of Debt Restructure That May be Obtained Under Chapter 11, Subject to Compliance with the Requirements of Chapter 11.**

- A term loan to a bank which has been accelerated is put back onto a monthly payment schedule.

- A line of credit which has matured is restructured to an amortizing term loan.

- Unsecured debt is paid from future profits of the Debtor's operations.

(f) **Other Obligations/Assets May be Preserved by a Timely Filing under Chapter 11**.

- Defaults under a lease of an important site may be cured and the leasehold preserved, **provided the petition is filed before the lease is terminated**.

- Defaults under a significant license, franchise or similar arrangement may be cured and the contractual rights preserved, **provided the petition is filed before the contractual rights are terminated.**

Practice Consideration: Counsel must study the terms of an important contract, license, distribution agreement or lease very carefully. If the Debtor's rights under the agreement are terminated in accordance with the terms of the agreement before the Debtor files in bankruptcy, the filing may be unable to alter the termination or restore the Debtor's rights. Haste, even great haste, is sometimes necessary in this context.

(g) **Chapter 11 Affords an Opportunity to Sell the Assets of a Going-Concern Free and Clear of Liens and Claims.**

One of the principal benefits and uses of chapter 11 is the ability to obtain a Bankruptcy Court Order under 11 U.S.C. sec. 363 authorizing the sale of a Debtor's assets free and clear of liens and claims. In this manner, a going-concern business can consummate a sale of assets free of the claims of secured and unsecured creditors. Such a Court Order may be required by a buyer so that the buyer knows that its use and possession of the Debtor's assets will not be disturbed by unsatisfied creditors of the seller. Moreover, such a Court Order may be a practical necessity to clear the assets of consensual or non-consensual liens.

Practice Consideration: The benefit of Code section 363 is that it allows a transaction to proceed that could not be accomplished absent the special power of the Bankruptcy Court. Valid liens and attachments attach to the proceeds of the sale in the same order of priority as they had on the assets themselves. In this manner, the property interest of the lien holder is respected: the lien is transferred from the asset to the proceeds of the asset. The lien holder, however, cannot prevent the Debtor from selling the asset. But see the next Practice Consideration.

Practice Consideration: Lenders often cooperate with and benefit from a sale under Code section 363. After all, a secured creditor's remedy is the sale of the collateral and if the Debtor will do the job for the Bank, so much the better. However, occasionally, the Lender will argue that the purchase price for the sale of the Debtor's assets is too low. In that context, the Court may permit the Lender to credit-bid for the assets. See Code sec. 363(k). A successful credit-bid by the Lender will, of course, prevent the going concern sale from proceeding. The burden is on the Debtor and its counsel to convince the Lender that the price offered for the assets is more than the Lender would receive if the Lender foreclosed its liens.

(h) **Chapter 11 Affords an Opportunity to Obtain Financing on a Senior Secured Basis.**

Under Code section 364, a debtor may borrow money and grant a lien that takes priority over the lien of existing secured creditors. The Bankruptcy Court will only authorize a priming lien if the Debtor demonstrates that the interests of existing creditors in the collateral are adequately protected. If the Debtor has equity in its existing assets or if the Debtor requires debt to acquire new assets post-petition, the combination of Code section 552 which cuts off floating liens and Code section 364 which permits post-petition secured borrowing can enable a Debtor to achieve its short term goals of access to debt financing notwithstanding a lack of cooperation from existing lenders.

(i) **Chapter 11 Confirmation Issues.**

The Plan of Reorganization (the "Plan") is the legal document that describes the treatment of the pre-petition claims against the Debtor. The Plan groups the claims against the Debtor into classes and then describes the treatment afforded the various classes. The creditors vote by class on whether to accept the treatment offered in the Plan. Before the Plan can be distributed to the creditors, however, the Court must approve a Disclosure Statement or prospectus that will be transmitted with the Plan to the creditors. This section of the materials discusses the following topics:

- Classification and Voting;

- The Disclosure Statement; and

- Plan Confirmation Issues.

A. Classification and Voting.

Code section 1122 provides that the Debtor's Plan may divide the pre-petition claims and equity interests into classes of like claims and interests. Only "substantially similar" claims or interests may be included within a single class. A class may contain a single claim or it may contain hundreds of claims. In a reorganization proceeding of an operating company, for example, general unsecured creditors of the Debtor often comprise a single class. Accordingly, the Plan describes the various classes of claims and the treatment afforded those classes by the Debtor.

The classification process is important because (i) all claims or interests in the class receive the same treatment (See Code section 1123(a)(4)) and (ii) voting on the Plan is undertaken by class. Under the special voting rules of chapter 11, a class is deemed to have voted in favour of a Plan (and all claims in the class are bound by the Plan) if, *of those who actually cast ballots*, a majority of the holders of claims in the class vote in favour of the Plan *and* the holders of claims totalling two-thirds in dollar amount vote in favour of the Plan. See Code section 1126(c) and (d). The need to have only substantially similar claims in the same class follows from the ability of less than all class members to bind the entire class with respect to the proposed treatment in the Plan. Because the minority can be compelled to accept the Plan treatment approved by the majority, it is essential that the legal rights of class members be substantially similar. Similarity is based on the nature of the claim or interest, not the identity of the holder of the claim or interest.

The following are common classification schemes in a Plan:

- A separate class for each secured creditor;
- A separate class for each group of creditors holding priority claims under Code section 507;
- A class of general unsecured claims;
- A class of de minimis unsecured claims (See section 1122(b);
- A class of insider claims; and
- A class of equity holders.

The following classifications are objectionable and will not ordinarily be approved by the Court:

- A class consisting of secured and unsecured creditors (note that the unsecured portion of a secured creditor's claim may be classified with other unsecured claims);
- A class consisting of unsecured creditors and interest holders;
- A class consisting of priority and general unsecured claims; or
- A class consisting of preferred and common interest holders.

B. The Disclosure Statement.

Code section 1125 provides that an acceptance or rejection of a Plan cannot be solicited from a holder of a claim or interest unless, at or before such solicitation, there is transmitted to the holder of the claim or interest a court approved Disclosure Statement. The Court shall approve the Disclosure Statement only if it contains “adequate information”.
Section 1125(a) defines “adequate information” as follows:
Adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgement about the plan, but adequate information need not include such information about any other possible or proposed plan.

The Disclosure Statement typically contains a discussion of the following topics:

- The history of the debtor and the circumstances surrounding its filing under Chapter 11;

- Material events occurring during the course of the Chapter 11 proceeding, such as a Cash Collateral Agreement, Debtor-in-Possession financing, rejection of certain executory contracts or the sale of certain assets;

- The financial performance of the Debtor while in Chapter 11;

- A description of the various classes of claims and interest holders and the treatment afforded those classes;

- A statement as to whether the holders of claims or interests in the respective classes are impaired (See below in connection with sections 1129(a)(7) and 1129(a)(10);

- A discussion of the means by which the Debtor will effectuate the Plan;

- A comparison of the treatment afforded claims and interests under the Plan with the treatment of those claims and interests were the Debtor liquidated under Chapter 7 of the Code (See below in connection with section 1129(a)(7);

- An estimate of anticipated administrative claims, including attorney’s and accountant’s fees and the means to pay those obligations;

- Disclosure respecting ownership and control of the Reorganized Debtor;

- The value of avoidance actions and the Debtor’s intentions with respect to the collection of avoidance actions.

As a general rule, objections to the confirmation of a Plan should not be raised in the context of the Court hearing on the adequacy of the Disclosure Statement. The Court naturally prefers to consider objections to confirmation at the hearing on confirmation and not at the hearing on the adequacy of the

Disclosure Statement. However, considerations of economy and efficiency weigh in favour of considering objections to a Disclosure Statement on the basis that the Plan described in the Disclosure Statement is facially non-confirmable. The following objections, therefore, may be considered by the Court in the context of a hearing on the Disclosure Statement:

- Claims or interests are improperly classified in the Plan;

- The Plan will violate the Absolute Priority Rule because creditors or interest holders will retain value under the Plan when senior claims or interests will not consent to the Plan;

- The Plan attempts to release parties other than the Debtor from liability for a claim;

- The Plan relies upon assumption of an executory contract that can no longer be assumed;

- The Plan terms do not comply with other applicable laws.

Even if the Court declines to hear the objection in the context of the Disclosure Statement hearing, the objection process will educate the Court with respect to likely contested issues in the context of confirmation.

C. Confirmation Requirements.

1. General Requirements.

Code section 1129 contains numerous requirements that must be satisfied as a condition to confirmation of a Plan of Reorganization. The purpose of this section of the materials is to highlight some of the most generic requirements, because these requirements are applicable in every case and because familiarity with these requirements will assist counsel in recognizing those Debtor proceedings that some promise of success and those that do not.

Section 1129(a)(7) provides that with respect to each impaired class of claims, each holder of a claim in that class must have accepted the Plan or each such holder will receive on account of the Plan at least as much as it would receive in a chapter 7 proceeding involving the Debtor. This is known as the “best interests” of creditors test. The Plan must treat creditors at least as favourably as would a liquidation of the Debtor. Accordingly, the Plan or, as is more common, the Disclosure Statement, must contain a hypothetical chapter 7 liquidation of the Debtor so that the treatment under the Plan can be compared to the treatment in the event of liquidation.

Section 1129(a)(8) provides that each class of claims must either have accepted the Plan or such class may not be impaired under the Plan. These requirements are critical. First, impairment means that the legal rights of the holders of the claims are adversely affected. The simplest example is that of an ordinary unsecured creditor. The legal right of that creditor is to be paid in full, in cash. If the Plan does anything other than pay that creditor in full, in cash, the holder of the claim is impaired within the meaning of the Bankruptcy Code. Accordingly, creditors are almost always “impaired”, because the Plan adversely affects their rights. If creditors are impaired, therefore, they must accept the Plan **as a class** or the Plan cannot be confirmed absent use of the exceptions contained in Section 1129(b). There is no easy way out of the box created by Section 1129(a)(8) as can be seen with respect to the discussion of the absolute priority rule in the next section.

Practice Tip: Because impaired classes must vote to accept the Plan, the make-up of the various classes and the voting rules of chapter 11 are of utmost importance. Debtor's counsel has some discretion in the design of the classes, although the basic rule is set forth in Code section 1122 that "substantially similar" claims must be classified together. Because the unsecured creditor class is almost always impaired, Debtor's counsel is actually assisted by the existence of a Creditors' Committee with whom the Debtor may negotiate. A Plan approved and endorsed by the Committee will likely achieve the affirmative vote of the unsecured creditor class.

Section 1129(a)(9)(A) contains the requirement that the Plan must provide for the payment of administrative claims (and certain other specialized claims) in cash on the effective date of the Plan. Administrative claims are the ordinary and necessary expenses of operating the Debtor during the post-petition period. Administrative claims also include the claims of professionals, as allowed by the Court.

Section 1129(a)(9)(B) contains the requirement that if the class or classes containing certain specified priority unsecured claims rejects the Plan, those claims must be paid in full in cash on the effective date of the Plan or if the class or classes containing those claims accepts the Plan, those claims must nonetheless receive payments under the Plan of a present value equal to the allowed amount of such claim.

Section 1129(a)(9)(C) contains the requirement that certain pre-petition, unsecured tax claims against the Debtor, including income, sales and withholding taxes, must be paid in full under the Plan, with interest, over no more than six years.

Section 1129(a)(10) contains the requirement that if a class of claims is impaired under the Plan, at least one class of impaired creditors has approved the Plan. This is the "somebody has to think the Plan is a good idea test".

Section 1129(a)(11) contains the requirement that the Court determine that the confirmation of the Debtors Plan is not likely to be followed by the further financial reorganization of the Debtor. In other words, the Court must determine that the Plan is feasible.

2. The Absolute Priority Rule.

Section 1129(a) (8) required that each impaired class accept the Plan. Section 1129(b), however, sets forth those circumstances under which the Court may confirm a Plan notwithstanding the Debtor's failure to satisfy the requirement of 1129(a)(8). Section 1129(b) provides that the Court may confirm the Plan notwithstanding the failure to comply with (a) (8) provided the Plan is fair and equitable and does not discriminate unfairly.

Fair and Equitable with respect to a class of secured claims, means that the Plan cannot be confirmed over the objection of an impaired class of secured claims unless (i) the secured creditor retains its interest in the property of the Debtor and (ii) the secured creditor receives under the Plan deferred cash payments with a present value at least equal to the value of the secured creditor's interest in the Debtor's property.

Assume a class containing a single claim held by a secured creditor with a first priority lien on the Debtor's machinery and equipment. Assume the claim is in the amount of $500,000 and the property of the Debtor is worth more than that amount. Assume also that the claim is impaired because the Debtor is going to increase the term of the payout. If the holder of the claim votes against the Plan, the Debtor may still confirm the Plan provided that the Plan provides that (i) the secured creditor retains its lien on the property and (ii) the Debtor will pay an amount over time equal to the present value of the secured creditor's interest in the property. This means simply that the Debtor must provide the creditor a stream of payments worth $500,000. The only way this can be done is with a market rate of interest added to the $500,000 payment.

Assume now that the creditor's claim is $500,000, but the value of the collateral is only $300,000. In this context, the Plan may be confirmed over the objection of the creditor holding the secured claim by means of a Plan that (i) allows the creditor to retain its lien and (ii) pays the creditor an amount over time with a present value of $300,000. However, in this example the creditor still holds an unsecured claim for $200,000 and that claim must also be classified and dealt with under the Plan.

Practice Tip: Confirmation of a Plan over the objection of a non-consenting, impaired secured class is relatively easy. It merely requires that the Plan pay the secured creditor the present value of the amount of the secured creditor's claim and that the Plan leave the secured creditor's lien intact. Since secured debt is often paid over time with interest, this requirement is often consistent with the Debtor's business plan. Is this arena, the battle will often be over whether the Debtor's Plan is feasible such that the creditor can reasonably expect the Debtor to fulfil the Plan terms. The parties may also disagree over the applicable interest rate necessary to achieve the correct present value.

3. The 1111(b) Election. The Bankruptcy Code gives the under-secured, secured creditor one more trick, however. Under Code section 1111(b), the under-secured, secured creditor can elect to have its entire claim remain secured by the property that serves as collateral, even if the collateral presently has a value of less than the amount of the claim. If the secured creditor makes this election, it gives up its deficiency, unsecured claim in the reorganization proceeding. If the under-secured creditor makes the election, the Debtor must now pay the creditor the full amount of its claim over time, but the present value of that payment stream need only equal the current value of the collateral securing the creditor's claim. The creditor's lien remains on the property and the creditor can benefit from any future appreciation in the value of the collateral.

The 1111(b) election is not available if the secured creditor holds a recourse claim against the Debtor and the Debtor proposes to sell the property pursuant to a Plan or under Code section 363. The election is not available in these circumstances because the secured creditor can credit bid the full amount of its claim in the context of any such sale.

Fair and Equitable with respect to a class of unsecured claims, means that unless the claims in the class are paid in full under the Plan or the class votes to accept the Plan, the Plan cannot be confirmed over the objection of an impaired class of unsecured claims if the equity holders of the Debtor may retain or receive anything of value under the Plan. Code Section 1129(b)(2)(B).

In other words, the owners of the Debtor cannot retain ownership in the reorganized Debtor unless the unsecured creditors are paid in full under the Plan or each class of unsecured creditors consents to the treatment afforded under the Plan.

Notwithstanding this powerful legal blocking position held by unsecured creditors acting as a class, the unsecured creditors frequently consent to Plans in which they are not paid in full and in which the Debtor's insiders retain ownership of the Debtor. The reason this occurs is entirely practical: In many cases, if the Debtor's insiders do not retain ownership of all or most of the equity in the reorganized Debtor, there will be no reorganization at all. Instead, the insiders may give up hope of reorganization and allow the Debtor to be liquidated. Liquidation often leaves nothing for the unsecured creditors. Viewed in a more positive light, unsecured creditors may allow the Debtor's insiders to retain ownership because they want the insiders to be motivated to work hard and make the Debtor successful. This is especially relevant in the majority of cases where unsecured creditors will receive payment only from the future profits of the Debtor. In other words, the "bargain" struck by unsecured creditors and insiders is that the insiders can retain ownership (and, frequently, jobs) as long as a portion of the Debtor's future profits are paid to the unsecured creditors. In most instances, it makes little economic sense for the unsecured creditors to attempt to block reorganization altogether, although the unsecureds can be expected to hold out for the best treatment they can negotiate.

4. The New Value Exception to the Absolute Priority Rule.

The bankruptcy and Article Three federal courts are split as to whether an exception for new value exists to the Absolute Priority Rule as it relates to a non-consenting class of unsecured creditors. The new value exception would permit existing equity owners to retain ownership in the reorganized debtor notwithstanding the negative vote of a class of unsecured creditors who are not paid in full. The "exception" to the absolute priority rule existed under Pre-Code case law and practice. Uncertainty exists as to whether the exception survived enactment of the Bankruptcy Code and codification of the Absolute Priority Rule in section 1129(b)(2)(B). Since Congress chose to codify the Absolute Priority Rule in section 1129(b)(2)(B), but did not codify the new value exception to the rule, the argument goes, Congress must have intended not to permit the new value exception to survive codification of the Bankruptcy Code. This analysis is too simplistic, however,

Those courts that have recognized the exception to the Absolute Priority Rule have set forth the following requirements:

- Old equity must make a new contribution (i) in money or money's worth, (ii) that is reasonably equivalent to the value of the new equity interests to be acquired in the reorganized debtor, and (iii) that is necessary for implementation of a feasible plan of reorganization.

The requirement that the contribution be money or money's worth has been more strictly applied by the Courts. Without deciding whether the new value exception exists, the Supreme Court ruled in Norwest Bank v. Ahlers, 485 U.S. 197 (1988) that post confirmation services provided by an insider will not suffice as new value. The Seventh Circuit has ruled that the contribution must be "an up front infusion of money or money's worth". In re Synder, 967 F.2d 1126, 1131 (7th Cir. 1992).

The court must also conduct a valuation hearing to determine if the proffered new value is reasonably equivalent to the value of the interests in the Debtor to be retained. Notably, some courts have ruled that equivalence does not exist where the contribution to the Debtor will not redound to the benefit of creditors, but will simply increase the value of the equity to be acquired. See In re One Times Square Associates Ltd. Partnership, 159 B.R. 695 (Bankr. S.D.N.Y. 1993), aff'd 165 B.R. 773 (S.D.N.Y), cert denied, 513 U.S. 1153 (1995); In re Miami Center Associates, Ltd., 144 B.R. 937 (Bankr. S. D. Fla. 1992).

Some courts have construed the necessity requirement narrowly and have required that the proposed new value be necessary to enable the reorganized debtor to operate successfully post confirmation. In re Tucson Self Storage, Inc., 166 B.R. 892, 899 (B.A.P. 9th Cir. 1994); In re Sovereign Group, 142 B.R. 702, 708 (E. D. Pa 1992). Other courts have ruled that the necessity requirement is satisfied merely by showing that the old equity holders are "the most feasible source" of fresh capital. In re Potter Material Services, 781 F.2nd 99, 102 (7th Cir. 1986; Bonner Mall Partnership v. U.S. Bancorp Mortgage Co., 2 F.3d 899, 911 (9th Cir. 1993).

The United States Supreme Court has declined the opportunity to rule expressly whether the new value exception remains good law in three recent cases, the most recent of which is Bank of America NT & SA v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999). In 203 North LaSalle, the Court subsumed the new value analysis with an analysis of the statutory requirements of Code section 1129(b)(2)(B). The Court focused on the meaning of the text in section 1129(b)(2)(B) providing that old equity cannot receive or retain any property *"on account of"* its old equity interest in the Debtor. The Court suggested three possible meanings for the language:

(1) Old equity may not receive or retain anything of value under the Plan under any circumstances if a senior class is not paid in full or does not consent;

(2) Old equity may not exchange its old equity for new equity, unless it makes a substantial new value contribution; and

(3) Old equity may not retain equity in the reorganized debtor if the price paid by old equity is at a price that is less than "the greatest possible addition to the bankruptcy estate".

The Court rejected the first interpretation since it would always preclude insiders from retaining equity in the reorganized debtor and "old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity for value reorganization." 119 S. Ct. at 1421. The Court implicitly rejected the second formulation on the basis that it is incomplete: If old equity is to retain an interest in the reorganized debtor it must not only “pay” for it with new value, but it must be demonstrably clear to the Bankruptcy Court that no other person would pay more.

The Court wrote approvingly of the third meaning given to the statutory requirement that insiders cannot retain an interest “on account of” of their old equity position, but the Court refused to adopt such a rule because it found that the Plan at issue in the case failed the third test even if it were good law. The Plan at issue failed the test because of the Plan provisions that “vested equity in the reorganized business in the Debtor’s partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan.” 119 S.Ct. at 1422.

The most that can be said with respect to the “new value exception”, therefore, is that the Supreme Court may accept a Plan under which old equity retains an interest in the reorganized debtor over the objection of a class of creditors who are not paid in full only if it is clear that all parties in interest have had an equal opportunity to bid on the equity and that, notwithstanding such opportunity, no other party would pay more than the amount offered by old equity. As a practical matter, therefore, insiders faced with a non-consenting class of unsecured creditors must either be prepared to terminate exclusivity to permit any party to file a Plan with respect to the Debtor or the Debtor must promulgate a Plan under which the equity in the Debtor will be auctioned to the highest bidder.

INSOL INTERNATIONAL

2-3 Philpot Lane, London EC3M 8AQ, UK
Tel: +44 (0)20 7929 6679
Fax: +44 (0)20 7929 6678
www.insol.org