INSOL INTERNATIONAL

DIRECTORS IN THE TWILIGHT ZONE IV

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International Association of Restructuring, Insolvency & Bankruptcy Professionals

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Foreword & Acknowledgement

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 few. 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 fourth edition.

The first edition of the book covered thirteen jurisdictions from across the continents. The second edition added six countries, the third two countries and this, the fourth, adds Vietnam, while updating the existing contributions. Many INSOL members have generously given of their time and expertise in writing about their jurisdictions.

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 continue to 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 on pages iv - v – without their hard work and dedication we would literally have had no end product. In terms of assisting financially with enabling us to publish this book, we are grateful to the Trustees of the Barbican Settlement, Artemis Trustees Limited, for kindly providing us with a grant in this regard. Their continued support for INSOL's work is greatly appreciated. INSOL also thanks the Group of 36 for its vital support.

Finally, I would like to record my personal debt of gratitude to my colleague Helen Pattinson, the General Editor, who updated the English version and shouldered the main burden of editing contributions.

Each contributor has stated his/her view of the position in their respective jurisdiction as at 1st December 2012.

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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 or if the company is balance sheet insolvent or unable to pay its debts as they fall due.

- **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 executive, 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.

International survey

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

> **High risk** In France there is (or used to be) 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.
>
> It is said that the liability is high in Spain, Portugal and some South American countries – which impose a negligence standard but it would be necessary to meticulously compare the case laws.
>
> **Medium risk** e.g. England, Ireland, Australia, New Zealand, Singapore, Hungary. 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. The provisions in Australia and Ireland are to a very similar effect. English case law has mitigated the liability. There are broad equivalents in the Netherlands, Belgium and Japan by case law.

Low risk e.g. United States. The personal liability of officers and directors for deepening the insolvency 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 deepening the insolvency on the lines of those found in Europe and English-based jurisdictions. Case laws rejected the concept. 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 very tolerant business judgment rule. Canada is generally low risk.

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. 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, attracts 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.

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ARGENTINA

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 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[1], 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 *(quiebra)* or (b) the filing by the debtor of a then frustrated reorganisation proceeding *(concurso preventivo)* (ABL 116):

(a) gratuitous acts (ABL 118 1);

(b) the prepayment of debts payable only on the day of judicial pronouncement of bankruptcy or thereafter (ABL 118 2);

(c) any kind of security granted to secure an obligation not yet due (ABL 118 3);

(d) acts which cause damage to creditors if the other party was aware of the company's insolvency at the time of the act (ABL 119).

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. These attacks on the transactions' efficacy may come under general (civil) law principles, under insolvency law, or under corporate law.

[1] Argentina Bankruptcy Law 24.522 (ABL) was sanctioned on 20 July 1995 and published at the *Boletín Oficial* (Official Gazette) number 28203 on 9 August 1995 *(Anales de Legislación Argentina* 1995 - D, 4381). Since then, it has been modified by numerous laws. They are hitherto cited by law number, its publication date, and a Spanish short title for each law:
Law 24587, 22 November 1995 *(Nominatividad de los títulos valores privados)*.
Law 24760, 13 January 1997 *(Factura de crédito. Régimen legal - su aprobación)*.
Law 25113, 21 July 1999 *(Contratos de maquila. Regulación legal)*.
Law 25284, 02 August 2000 *(Entidades deportivas. Régimen especial de administración)*.
Law 25374, 02 January 2001 *(Mutuales. Ley 20321 - modificación)*.
Law 25563, 15 February 2002 *(Concursos y quiebras. Emergencia productiva y crediticia)*.
Law 25589, 16 May 2002 *(Ley de concursos y quiebras. Leyes 24522 y 25563 - su modificación)*.
Law 25640, 11 September 2002 *(Concursos y quiebras. Ley 25589 - prórroga)*.
Law 25750, 07 July 2003 *(Preservación de bienes y patrimonios culturales. Bienes y patrimonios culturales - régimen)*.
Law 25972, 17 December 2004 *(Emergencia pública. Ley 25561 - prorrógase artículos)*.
Law 26086, 11 April 2006 *(Concursos y quiebras. Ley 24.522 - modificación)*.
Law 26684, 30 June 2011 *(Concursos y quiebras)*.
A full Spanish version – for both the original and the updated version of ABL - is currently available at the Ministry of Economy website: http://www.infoleg.gov.ar/infolegInternet/verNorma.do?id=25379. For the texts of all modifying laws, refer to: http://www.infoleg.gov.ar/infolegInternet/anexos/25000-29999/25379/texact.htm.

1.2.2 Attacks based on general (civil) law do not depend on the existence of formal insolvency proceedings; they should be based on the Argentina Civil Code (ACC), ACC 961 to 971, or ACC 955 to 960.[2]

1.2.3 Under insolvency law, personal liability on the part of directors or officers - for transactions entered into during the "twilight" period may not be raised by creditors unless a formal insolvent liquidation - and not a reorganisation - procedure follows.

1.2.4 Under corporate law, 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 19550[3], ACL 59 and 279), irrespective of whether or not formal proceedings have been instituted.

1.2.5 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 (ACL 279).[4]

1.3 Does it depend on the nature of the transaction?

1.3.1 The length of the "twilight" period does not depend on the nature of the transaction. 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 *síndico* (the judicially appointed trustee or insolvency administrator) is not necessary (ABL 118). Acts under 1.1.2(d) require proceedings to be instigated by the *síndico* in order for a judicial decision to be reached declaring the act void vis-à-vis the creditors. The *síndico* must obtain previous authorisation by the simple majority (more than a half) of the admitted unsecured liabilities (ABL 119). A creditor may also pursue the same action at its own cost and risk, but only after petitioning the *síndico* to do so, and waiting 30 days for the *síndico* 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. In addition, success in an action pursued by a creditor under ABL 120 results in the creditor obtaining reimbursement of its cost, and a priority being awarded to it. The priority is determined by the judge, and should be between a third and a tenth of the recovered assets value, but limited to the creditor's claim against the estate.

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 may be significant in determining whether the related party may be held personally liable upon the formal liquidation proceeding of the company. In this case, liability does not merely imply the transaction's voidance, but may, on occasions, imply the counterparty's declaration of bankruptcy (ABL 161).[5]

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.[6] In fact, this is not properly a case of lengthening the "twilight" period, but of beginning its counting earlier.

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[2] Actions *(acción revocatoria)* based on ACC 961 aim at declaring void an act of the debtor in fraud *(fraude)* to its creditors. For this action's success, ACC 962 requires: (i) the debtor to be insolvent, though not necessarily under formal insolvency proceedings; (ii) prejudice to creditors to be caused by the transaction or that the debtor was insolvent prior to the transaction; and (iii) the action to be exercised by a creditor with a claim prior to the voidable transaction. For the purpose of this action, fraud may be defined as provocation or aggravation of the debtor's insolvency through acts or omissions, in prejudice to its creditors, deviating assets from its patrimony or estate. Actions *(acción de simulación)* based on ACC 955 to 960 are directed towards declaring the transaction simulated, thus inopposable to creditors. This action may be instituted by creditors who are prejudiced or will suffer prejudice by the transaction, the insolvency of the debtor not being necessary.

[3] Argentina Corporation Law 19.550 (ACL) was sanctioned on 3 April 1972 and published in the Boletín Oficial number 22409 (Official Gazette) on 25 April 1972. Since then, it has been modified by numerous laws. The current text has been reordered by Decree 841/1984. A full Spanish version - for both the original and the updated version of the ACL - is currently available at the Ministry of Economy website: http://www.infoleg.gov.ar/infolegInternet/verNorma.do?id=25553. The following is a summary of laws which have amended the original ACL, as sanctioned by Law 19550 (laws are cited by law number, their publication date, and their Spanish short title:

Law 22315, 07 November 1980 *(Inspección General de Justicia. Ley Orgánica)*.

Law 22903, 15 September 1983 *(Sociedades Comerciales. Su Modificación)*.

Law 23576, 27 July 1988 *(Títulos. Creación de un nuevo título de deuda. Obligaciones negociables de sociedades anónimas)*.

Law 23697, 25 September 1989 *(Emergencia económica. Estado de emergencia)*.

Law 23962, 06 August 1991 *(Impuesto a las ganancias. Obligaciones negociables)*.

Law 24076, 12 June 1992 *(Gas Natural. Marco Regulatorio. Privatización Gas del Estado)*.

Law 24145, 06 November 1992 *(Y.P.F. Privatización)*.

Law 24435, 17 January 1995 *(Sociedades Comerciales. Modificaciones)*.

Law 24522, 09 August 1995 *(Concursos y quiebras. Régimen legal)*.

Law 26047, 03 August 2005 *(Registros Nacionales. Sociedades - Asociaciones - Fundaciones - Disposiciones)*.

[4] Actions *(acción individual de responsabilidad)* based on ACL 279 aim at repairing the damage caused by the corporation's directors or supervisory board members *(sindicatura or consejo de vigilancia)*, ACL 298 and 280. These actions may be exercised by either shareholders or third parties, and are directed towards the directors' personal assets ("patrimony"). Damages to be redeemed through this action include affecting the shareholders' rights to participate in the corporation assemblies, voting or other shareholder rights.

[5] Refer to 2.2.4 below for further information.

[6] Refer answer to 1.1.1.

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. The action against directors or officers requires proceedings to be instigated by the *síndico*, which must obtain previous authorisation by the simple majority (more than a half) of the admitted unsecured liabilities (ABL 174 and 119). Creditors, at their own cost (ABL 120), have a subsidiary action if the *síndico* does not seek or obtain authorisation (ABL 176 and 120).[7]

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. 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). This is understood to imply the duty of directors to administer the corporation, by performing a number of activities, being informed of the development of corporate trade, participating in board meetings, and observing decisions by the board or by creditor's meetings which are contrary to ACL or bylaw provisions. Thus, directors are not responsible for their administration's success, but for their loyalty and diligence in performing their duties. Their performance is assessed based on the circumstances at the time of their decision; the burden of proof is not on the director.

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 proceedings to ensure fair treatment to stakeholders, in particular to pre-insolvency general creditors.[8]

General fiduciary duties to creditors when directors serve during debtor-in-possession administration in a reorganisation proceeding may imply the director's personal liability for specific transactions entered into during administration. Liabilities may come under insolvency, corporate, criminal, tax, labour and other laws.

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

2.2.1 Liability under reorganisation proceedings *(concurso preventivo)*:[9] 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).[10] [11] Consequently, directors may be held liable for such actions. Statutory provisions provide a system of administration during reorganisation proceedings according to the following principles: (a) freedom to enter into any transaction within the debtor's ordinary course of business[12] *(administración 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);[13] 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).[14]

7 Success in an action pursued by a creditor under ABL 174 results in the creditor obtaining the same treatment as described in ABL 120, i.e. reimbursement of its costs, and a priority being awarded, determined by the judge, and legally limited to between a third and a tenth of the reparation, with a limit on the creditor's claim against the estate.

8 See 1.3.1.

9 It should be noted that, under a reorganisation proceeding ruled by ABL *(concurso preventivo)*, neither the *síndico* nor creditors may raise personal liability issues on the part of directors or officers, for transactions entered into by the company during the "twilight" period. However, creditors may file suits based on general (civil) law, which do not depend on the existence of formal insolvency proceedings. See 1.2.2. and 1.2.3.

10 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.

11 In addition to removing the debtor from the estate management, the transaction may be declared ineffective vis-à-vis the creditors.

12 Under Argentinean law, "ordinary course of business" is understood to mean activity ordinarily required to pursue the debtor's activity.

13 Though the general rule defines required judicial authorisation prior to entering transactions when they exceed the debtor's ordinary course of business, a few examples where authorisation is mandatory 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).

14 The prohibition purports to dispense equal treatment to similarly situated pre-insolvency creditors *(pars condicio creditorum)*, and draws a dividing line, at the time of presentation of the petition to commence an insolvency proceeding, between the mentioned creditors and post-insolvency ones.

2.2.2 Liability under liquidation proceedings *(quiebra)*: A director or officer may beheld 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 or officer (ABL 173, first part). The action should be brought by the *síndico* within two years of the judicial pronouncement of the liquidation proceeding (ABL 174).

Creditors only have a subsidiary or subordinated right to institute this action, when the *síndico* does not institute it (ABL 176 and 120).[15] Requirements for liability are: (a) action by a person with capacity to represent the debtor[16]; (b) entering transactions which produce, facilitate, permit, or aggravate the company's economic or financial situation; (c) performing the action deliberately (with *dolo*"[17]); and (d) damage to the company or its creditors.[18]

2.2.3 A director or officer may also be held personally liable if, during the "twilight" period, or after formal 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[19]; (b) participating in actions tending to diminishing the debtor's assets or exaggerating its liabilities; (c) performing the action deliberately (with *dolo*[20]); and (d) damage to the company or its creditors.[21] The action should be brought by the *síndico* within two years of the judicial pronouncement of bankruptcy (ABL 174). Creditors only have a subsidiary or subordinated right to institute this action, when the *síndico* does not institute it (ABL 176 and 120).[22] Liability extends to:

(a) the restitution of goods still under the director's or officer'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 Extension of liquidation proceedings to directors: 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 *"actuación en interés 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 a person's own interests is defined as (a) any natural or legal person, (b) appearing to act on behalf of the insolvent debtor, (c) entering into transactions in his own interests and making dispositions of company's assets as if they were his own[23] (d) in order to defraud the insolvent debtor's creditors (ABL 161.1).

2.2.4.2 Abuse of control is defined by ABL as the unlawful deviation of the controlled company's interest, subjecting it to a unified direction in the controller's interest or in the group's interest (ABL 161.2).[24] A controller[25] 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 any natural or legal person whose assets and liabilities, or the majority of them, cannot be clearly divided from those of the insolvent debtor (ABL 161.3). The most common example is of promiscuous or intermingled management of the mentioned assets and liabilities.

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 declaration of the controlling party's own bankruptcy. Though the provision does not specifically mention directors as liable under it, directors and officers may be reached when they meet the aforementioned criteria. In the case of control, it requires that: (a) the definition of control is applicable to them; and (b) they have abused such control.

2.2.4.5 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) and may be either an independent insolvency proceeding with a separate estate[26] or the formation of a single estate with assets from the original bankruptcy and the second bankruptcy.[27]

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[15] The creditor's success implies the consequences established under ABL 120, which have previously been described in footnote 7.

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

[17] *Dolo* is defined by art. 1072 of the ACC as requiring both knowledge and intention to produce damage.

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

[19] 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.

[20] Defined as in ACC 1072. See previous footnote.

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

[22] The creditor's success implies the consequences established under ABL 120, which have previously been described in footnote 7.

[23] This does not require for the deviated company's assets to be incorporated into the director's personal patrimony. In fact, only asset deviation is needed, and it must be the result of the fraudulent transaction.

[24] 19 The mere existence of control is not punishable under Argentinean law. On the contrary, ABL 172 specifically provides that control by itself does not imply the application of ABL 161 to 171. In addition, ACL also allows for the same interpretation.

[25] ACL 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. It should be noted that under Argentinean law, control by itself does not imply liability - only abusive exercise of controlling power may bring about the controller's personal liability or, in some circumstances, its liquidation ("by extension").

[26] The system is called separate estates *(masas separadas)* (ABL 168).

[27] The system is called unified estate *(masa única)* (ABL 167).

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

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 or continued regardless of the existence of insolvency proceedings (ABL 175). 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 and 274);

(b) any violation of the law, the company's articles of incorporation or bylaws (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, bylaws 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 Público 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 shareholders' meeting. The decision of the shareholders has the effect of automatically removing the director from his/her 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 shareholders' meeting (ACL 277). In a liquidation, this action must be filed or continued *(vis attractiva concursus)* before the bankruptcy court (ABL 175 and 176). 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 action in ACL 276, first part, in a liquidation this action must be filed or continued (vis attractiva concursus) before the bankruptcy court (ABL 175 and 176). 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.[28] 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 is personal to the plaintiff and not corporate[29]; consequently, the action is brought by the shareholder or third party under its own interest and not on behalf of the corporation.[30] This right of action arises from any loss caused to the shareholder's estate[31] 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.[32] Though it does not mention the controller's directors or officers as being liable, liability may be founded on the general principle of torts, under ACC 1109. There are two possibilities for actions under ACL 54. The 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*[33]). The requirement for ACL 54, second part, to proceed is the use by any controlling party of corporate funds or assets on the users of a third party's behalf. Restitution for this case implies restitution of the benefits obtained.[34]

2.4 Liability under APC (Argentina's Penal Code)[35]

2.4.1 The APC describes the criminal offences that may be committed by directors[36] 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 and officers 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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28 See comment in 2.3.2(a).
29 Thus different from actions from ACL 276 first and second parts. See 2.3.2(a) and 2.3.2(b).
30 Contrary to actions from ACL 276 first and second parts. See 2.3.2(a). and 2.3.2(b).
31 Damage to the shareholder's estate is usually understood to be damage to the value of shares.
32 This action is also applicable to damages caused to the company by its shareholders.
33 See footnote 7.
34 If there is loss, it is only suffered by the controlling party.
35 APC 178, 300 and 301 were all ratified by Law 23.077, which ratified Law-decree 21.338. APC 173 was enacted under Law 11.221, and recuperated application with the enactment of Law 23.077.
36 See the discussion in 3.3. for applicability to officers, members of the Supervisory Board, private supervisors, liquidators and corporate accountants.

(b) APC 300, inc. 3: the publication, certification, or authorisation of false or incomplete corporate documents. Directors may be charged with this offence and punished with imprisonment. The offence must have been committed deliberately and is punishable by imprisonment. The corporate documents to which this offence applies include balance sheets, inventories 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 deliberately consenting or participating in the performance of acts which are in violation of the law, articles of incorporation, and bylaws 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 and officers 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

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 ABL (Argentina's Bankruptcy Law 24.452)

3.1.1 The general rule[37] 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 (ACC 961 to 971 or ACC 955 to 960).

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)[38], (b) abuse of control (ABL 161.2)[39], and (c) a person having its assets and liabilities confused with those of the debtor under insolvency proceedings (ABL 161.3)[40]. Anybody who meets one of these criteria may suffer as sanction the extension of the insolvency proceedings. This is again known as *"quiebra refleja"*[41], 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[42]. However, persons acting in such circumstances could be reached by the application of the principles in 3.1.

[37] For a more specific case of liability for person's involved in company's affairs, see 3.1.2.
[38] See discussion in 2.2.4.1.
[39] See discussion in 2.2.4.2.
[40] See discussion in 2.2.4.3.
[41] See discussion in 2.2.4.4.
[42] ACL does not provide such concept either. However, ACL 34, second paragraph, asserts that the so called de facto shareholder *(socio oculto)* has unlimited and joint responsibility for corporate debts. Application of this concept in order to extend corporate insolvency proceedings to de facto shareholders under ABL 160 is debated by insolvency experts.

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

3.2.1 ACL establishes a general rule about corporate officials *(gerentes)* 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[43], but without in any way limiting the liability of the directors themselves (ACL 270).

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

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

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

(c) 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 described 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 (*síndico*) 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 APC (Argentina's Penal Code)

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, officers or managers *(gerente de la sociedad o establecimiento)* and the corporation's accountants.

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 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, under insolvency law, following commencement of liquidation proceedings (ABL 119).

4.1.2 A few transactions are automatically treated as void *vis-à-vis* creditors upon declaration of bankruptcy by the insolvency judge. In these cases, the judge may declare the transaction void without the need for a petition, and without any proceeding. Such declaration must be issued within three years of commencement of liquidation proceedings (ABL 124). Proceedings can also be brought by the *síndico* to challenge the 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. 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 originally unsecured obligation which was not yet due (ABL 118).

[43] Under ACL 270, the Board of Directors may designate officers to serve in executive functions in the administration. Directors may hold these positions

4.2 Reviewable transactions

4.2.1 Any transaction may be subject to challenge under the general rule set out in 4.1.1 if it impairs creditors' interests and the other party is aware of the company's insolvency at the time of the transaction. Proceedings must be brought by the *síndico*, with the prior approval of the majority of the verified creditors (ABL 119). Actions need to be initiated within three years of commencement of liquidation proceedings (ABL 124). The insolvency judge's decision is subject to appeal by the injured party.

4.2.2 Proceedings challenging a transaction on this basis may be brought by creditors of the company once formal insolvent liquidation proceedings have been commenced (ABL 120). The successful creditor obtains reimbursement of its cost, and a priority, determined by the judge, which should be established at between a third and a tenth of the recovered value, but limited to the creditor's claim against the estate.

4.2.3 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 action by the *síndico* or 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 (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. 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).

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 *(quiebra)* have been commenced, the authority and powers of the directors are taken over by the *síndico*. (ABL 108 and 110) 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 verified creditors for that purpose (ABL 118 and 176).

5.1.2 A creditor can bring an action if the *síndico* fails to do so, or fails to obtain the authority of the majority of creditors.

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 Corporate actions during insolvency proceedings. During insolvency liquidation proceedings *(quiebra)*, actions against directors, officers and members of the Supervisory Board, based on ACL 276 and 277[44], may be brought by the *síndico* (ABL 175) although shareholders and third parties retain the right to claim for personal damage suffered by them (ACL 279)[45].

5.2.2 Pre-existing corporate actions during insolvency proceedings. 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[46]. For pre-existing actions commenced by the corporation, the *síndico* must decide whether to continue the pre-existing proceeding or bring an action based on the insolvency law. For pre-existing actions commenced by a shareholder, the *síndico* must decide whether to co-operate in the pre-existing proceeding or bring an action based on 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 part), and others (ABL 173, second parts). The *síndico* must obtain the prior approval of the majority of verified creditors (ABL 120).

5.3.2 A creditor can bring the action if the *síndico* fails to do so (ABL 120) or if the *síndico* fails to obtain the required majority (ALB 119). The creditor does so at his own expense. However, if successful, he may be reimbursed and awarded a priority, determined by the judge, of between a third and tenth of the recovered value, but limited to the creditor's claim against the estate (ABL 120).

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[44] See discussion in 2.3.1 and 2.3.2.
[45] See discussion in 2.3.2.(d).
[46] In these cases, commencement of liquidation proceedings *(quiebra)* "attracts" these suits to the insolvency court *(vis attractiva concursus)*.

5.3.3 Actions based on Civil Law *(revocatoria ordinaria)*, for a declaration of fraud in relation to a particular transaction (based on ACC 961 to 972)[47] 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 a 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)[48] to:

(a) persons who acted in their own interests and disposed of the debtor's assets while leading third parties/creditors to believe they were the insolvent debtor (ABL 161, 1);

(b) any person who controls[49] the insolvent debtor and who has guided its conduct towards interests other than those of the insolvent debtor; in the controller's favour or in favour of another member of the corporate group (ABL 161, 2); or

(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 to the insolvency judge (ABL 162), 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) 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 co-operate

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

7.1.2 In liquidation proceedings, the directors, corporate officials and representatives of the insolvent company are obliged to co-operate with the *síndico* (office holder) and with the court, to provide information about the situation of the estate and/or the company's liabilities and assets. The court has the power to enforce this duty to co-operate. Accordingly, 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). However, although the court may enforce attendance, it may not force the director to incriminate him/herself (See description in 7.2.1.)

7.1.3 In reorganisation proceedings, any director who fails to provide the information required by the court and / or by the *síndico* (office holder) may be sanctioned to the point of being removed from office by the court (ABL 17). Such measure is appealable by the debtor.

7.2 Human rights

Article 18 of the National Constitution establishes that "no one is obliged to 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.

[47] See discussion on footnote 2.
[48] See discussion in 2.2.4.
[49] For the definition of control see 2.2.4.2.

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 ABL intending to declare certain acts void vis-à-vis the creditors[50] is three years from the declaration of bankruptcy (ABL 124). Personal liability actions brought under ABL 173, first[51] and second part[52] have a limitation period of two years from the judicial pronouncement of liquidation proceedings (ABL 174). Actions brought under ABL 161 have a limitation period equivalent to the time between declaration of bankruptcy and six months following the general report[53] by the *síndico* (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 that an appeal is not allowed unless the statute explicitly indicates otherwise (ABL 273.3).

Lower court decisions in actions brought under insolvency law intending to declare certain acts void vis-à-vis the creditors under ABL 118, 119 and 120 are subject to appeal (ABL 124). Lower court decisions on personal liability actions under ABL 173, first and second part may be subject to appeal depending on non-insolvency local procedural rules for ordinary proceedings (ABL 174). Lower court decisions extending insolvency under ABL 161 are subject to appeal as is any other declaration of bankruptcy (ABL 88).

QUESTION 9

9. Foreign corporations

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

9.1 General rule

9.1.1 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, although a company under liquidation proceedings in Argentina is bound to be wound up (ABL 235).

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

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 widely / extended insurance available to provide effective protection for directors against personal liability which may arise in connection with the liabilities discussed above.

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[50] See discussion in 1.1. and 1.3.2.
[51] See discussion in 2.2.2.
[52] See discussion in 2.2.3.
[53] The general report by the *síndico* (ABL 39) includes, among other legally required contents: a description of the causes leading to the debtor's financial 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 regards the estimated date when the debtor became insolvent, and the list of transfers that may be voidable (ABL 118 and 119).

QUESTION 11

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

11.1 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[54] 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 void vis-à-vis the creditors in a future liquidation proceeding[55].

[54] See discussion in Section 4.
[55] It should be remembered that for the transaction to be void, it requires the act to cause damage to creditors. See also discussion in 1.1.2 and 1.3.2.

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 transactions

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 preferences

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 the transaction was set aside and 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 or have since become extortionate because of a variation (s. 588FD).

[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. 144 of the Occupational Health and Safety Act 2004 (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) Unreasonable director-related transactions

A transaction where a company makes, or incurs an obligation to make, a payment, a transfer of company property, or an issue of the company's securities to a director or a close associate of a director, is an unreasonable director-related transaction if 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. 588FDA).

(f) 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]

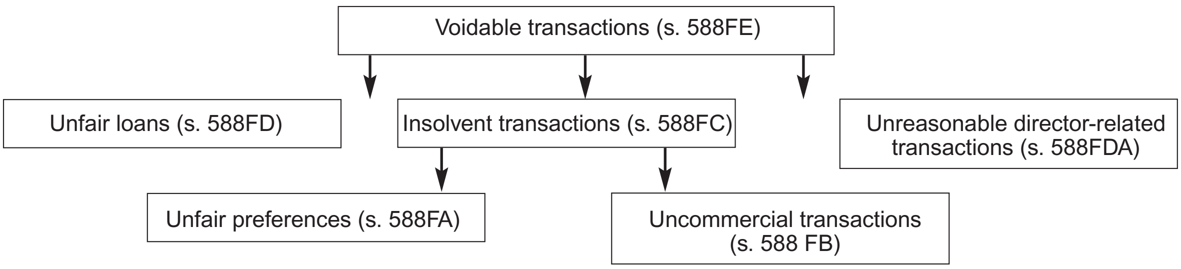
1.2 What time frames are involved?

1.2.1 Where a company is being wound up, past transactions may become voidable transactions pursuant to section 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.[5]

Type of transaction	Length of time prior to relation-back day	Section
Insolvent transaction (with non-related entity)	Six 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)	Two years	588FE(3)
Insolvent transaction to which a related entity[6] of the company is a party	Four 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	Ten years	588FE(5)
Unfair loan	No time limit until start of winding-up (which may be after the relation-back day)	588FE(6)
Unreasonable director-related transaction	Four years (or after the relation-back day but on or before the date when the winding-up began)	588FE(6A)

1.2.3 The following diagram[7] illustrates the meaning of a "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.[8]

[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] In addition to the items in the below table ss. 588FE(2A) and (2B) prescribe voidable transactions in relation to transactions of companies that are under Administration or subject to a Deed of Company Arrangement immediately before being wound up, where such transactions, being either an uncommercial transaction, unfair preference, unfair loan or unreasonable director-related transaction, are entered into without the authority of the Administrator or Deed Administrator. Such transactions must have been entered into between the start of the relation-back day and the date the company was wound up.
[6] 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.
[7] Based on layout suggested by Andrew Keays.
[8] 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).

No time limit until start of winding up	Unfair loan (s. 588FE(6))
Ten years	Insolvent transaction to defeat creditors (s. 588FE(5))
Four years	Insolvent transaction with a related entity (s. 588FE(4)); Unreasonable director-related transaction (s. 588FE(6A))
Two years	Insolvent and uncommercial transaction (with non-related entity) (s. 588FE(3))
Six months prior to relation-back day until start of winding up entity	Insolvent transaction (with non-related) amounting to an unfair preference (s. 588FE(2))
	Relation-back day (see note in 1.2.5)
Three years after the relation-back day or within such longer period as thecourt orders on application by theliquidator within those three years (s. 588FF(3))	Proceedings brought in respect of voidable transactions pursuant to sections 588FE and 588FF
Six 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)

1.2.5 Note: relation-back day is defined in section 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 (e.g. appointment of administrator) (s. 513C). In other cases (e.g. 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).

1.3 Circulating security interests

1.3.1 Any circulating security interest[9], which includes a 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 circulating security interest 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

(v) 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[10]

The following are the principal acts set out in the Corporations Act (there are others referred to in other legislation and the common law):[11]

(a) failing to prevent the company from incurring a debt while insolvent (insolvent trading) (s. 588G);[12]

9 Defined in s. 51C

10 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).

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

12 The director may also contravene s. 596 by: (i) fraudulently obtaining credit for the company (596(1)(a)), (ii) with intent to defraud the company or its creditors, transferring or charging any property of the company (596(1)(b)) or concealing or removing any property of the company after or within two months before the date of any unsatisfied judgment against the company (596(1)(c)). These are criminal offences: s. 1311.

(b) failing to exercise powers and discharge duties with care and diligence (s. 180);[13]

(c) not acting in good faith (s. 181);[14]

(d) misuse of position (s. 182);[15]

(e) misuse of company information (s. 183);[16]

(f) entering into an agreement or transaction to prevent or significantly reduce the recovery of employee entitlements (s. 596AB);[17]

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

(h) falsification of books; false and misleading statements and information (ss. 1307-1309).[18]

2.1.2 The Corporations Act (s.197) 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.

2.2 Liability for insolvent trading under section 588G

(a) Liability of a director may be:

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

- a compensation order (s. 1317H); or
- a civil pecuniary penalty order[19] (s. 1317G); or

(ii) criminal if dishonesty and suspicion of insolvency are involved (s. 588G(3)).[20]

There is to be no double recovery in actions for insolvent trading under section 588M (s. 588N).[21]

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).

(b) 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.

(i) 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.

(ii) If the ASIC[22] 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.

(iii) If the company[23] 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 company (under s. 588K) is equal to the creditor's loss.

(c) 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).

(d) 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.

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13 Liability is imposed on directors and other officers.
14 See above, footnote 13.
15 Liability is imposed on directors, other officers and employees.
16 See above, footnote 15. This duty continues after the person stops being an officer or employee of the company.
17 Liability is imposed on a "person", which includes a director.
18 Liability is variously imposed on a "person" or an "officer", which includes a director. See also related offences in s. 590.
19 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 – i.e. beyond reasonable doubt (e.g. 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).
20 Possibly in conjunction with a compensation order under s. 588K.
21 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".
22 Australian Securities and Investments Commission – the corporate watchdog.
23 Through the liquidator.

(e) The defences available are:[24]

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

(ii) 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 (ss. 588G(3)(c) and 588G(3)(d)); and

(iii) in relation to penal liability[25] – lack of material prejudice to the company or shareholders' interests and to the company's ability to pay its creditors, together with lack of seriousness of the contravention.[26] In addition, the above mentioned defences available in civil proceedings (s. 588H) apply here as well.[27]

Note 1: Division 5 of Part 5.7B (ss. 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: section 180

(a) Liability of a director may be both civil (s. 1317H) and criminal (s. 1311), and there is liability for a pecuniary penalty order under section 1317G.[28] 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).

(b) 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.

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

(d) 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.

(e) The defences available to a director are:

(i) proper "business judgment"[29] exercised: section 180(2); and

(ii) reliance on proper delegation: section 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 section 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]

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

(a) Liability of a director may be both civil (s. 1317H) and criminal (s. 184), and there is liability for a pecuniary penalty order under section 1317G.[31] 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).

(b) 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.

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

(d) 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.

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

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[24] Note that the "business judgment rule" in s.180(2) does not provide a defence to an insolvent trading claim (see below, footnote 29 and accompanying text, and note to s. 180(2)).

[25] That is, liability which arises from a contravention of a civil penalty provision of the Corporations Act (see above, footnote 19).

[26] 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.

[27] 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).

[28] That is, a quasi-penal order.

[29] 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 judgment 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)).

[30] See above, footnote 27.

[31] That is, a quasi-penal order.

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 section 1317G might not be satisfied, and hence a civil penalty order not imposed (but a compensation order may still be imposed under s. 1317H).[32]

2.5 Entering into an agreement or transaction to avoid employee entitlements in breach of section 596AB[33]

(a) Liability of a director may be:

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

(ii) criminal (s. 588G(3)[34] if insolvent trading to a criminal degree is also involved, or s. 1311 otherwise).

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

(b) Whether the liquidator or an employee[35] applies, the director is personally liable in respect of the loss suffered by the employee. Note that section 596AB is not a civil penalty provision, so ASIC cannot apply for relief.

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

(c) 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.

(d) 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.

(e) 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, at 2.2).

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 section 588FE: section 588FGA

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

(b) 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.

(c) 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 responsibility).

(d) 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.

(e) The defences available to a director are:

(i) expecting solvency on reasonable grounds, including reasonable reliance on a qualified person for advice (ss. 588FGB(3) and 588FGB(4));

(ii) 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

(iii) 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 section 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 1307-1309

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

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

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

(d) 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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[32] See above, footnote 27.

[33] 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).

[34] Possibly in conjunction with a compensation order under s. 588K.

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

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

(i) lack of intention to falsify books (s. 1307(3));[36]

(ii) acting honestly;

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

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

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

3.1.1 The Corporations Act specifies general duties of officers[37] of a company which will apply to their conduct during the "twilight" period.[38] Employees may also be liable for misuse of their position or information during and outside the "twilight" period.[39]

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.[40]

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

3.1.3 Under section 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 or is likely to suffer loss or damage (s. 598).

3.1.4 Division 5 of Part 5.7B (ss. 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 (e.g. directors if the provision imposes requirements on directors), but also for persons involved in the contravention.[41]

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.[42]

[36] 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.

[37] 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.

[38] 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.

[39] Sections 182 and 183.

[40] Section 9 (definition of "director"). A person will not be deemed a director merely because the directors act on advice given by the person in the proper performance of their professional capacity or their business relationship with the directors of the company.

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

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

3.2.2 An officer of a company will be subject to the duties contained in sections 180-183.[43] 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(1)(a)), transferring company property with intention to defraud (s. 596(1)(b)), concealing or removing any property of the company after or within two months before the date of any unsatisfied judgment against the company (s. 596(1)(c)), various offences under section 590[44], falsification of books (s. 1307[45]) 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 sections 181, 182 or 183 (i.e. 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[46]. The court may make a variety of orders;[47] 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)).

3.2.5 Under section 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 (ss. 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 section 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 ss. 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)[48] 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 section 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.

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.

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[43] 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.

[44] Note that s. 590 also applies to employees of the company.

[45] Note that s. 1307 applies to officers, former officers, employees, former employees, members and former members.

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

[47] Section 588FF.

[48] 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 in the same circumstances.

QUESTION 4

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[49] transactions being set aside

4.1.1 A creditor may be ordered to repay an unfair preference that occurred during the six-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 four years if a related entity is involved and ten years if the purpose of the payment was to defeat creditors.[50] A creditor may be ordered to forego the benefit of an uncommercial transaction during the two 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.

In any of these cases the court may make a range of orders under section 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.[51]

4.1.5 A circulating security interest[52] created within six 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 circulating security interest was created.[53]

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 section 588FG:

(a) a non-party is not to be the subject of an order materially prejudicing its interests if that non-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

5. Enforcement

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

5.1 The company

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 in the best interests of the company as a whole. The liquidator has power by reason of section 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.[54]

[49] The expression "counter-party" is not used in Australian law; rather the expression "third party" is used.
[50] See table in question 1.
[51] Section 588FH.
[52] Defined in section 51C and includes a floating charge.
[53] Section 588FJ. See further the answer to question 11(b).
[54] See above, footnote 10.

5.1.3 Finally, the company may apply for a compensation order if a civil penalty provision has been breached: (s. 1317J(2)).

5.2 The liquidator

5.2.1 In the event that the court exercises its power under section 474(2) to vest property of the company (including the company's claims, e.g. 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[55] and for causing the company to undertake a transaction which has the purpose of defeating claims by employees to their entitlements.[56]

5.2.3 The liquidator also has a statutory right to make an application to the Court against those guilty of fraud, negligence, default, breach of duty or breach of trust in relation to the company.[57]

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.[58]

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.[59] 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.

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.[60]

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.[61]

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:[62]

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

(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 21 days.

However, where three months has lapsed after the due date for payment of those tax liabilities, the directors are unable to avoid personal liability for the company's unpaid debts as the director penalty cannot be remitted by the administration or winding-up of the company.[63]

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 section 588FE such that an order under section 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 section 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 section 588M(3) for unpaid taxes and duties.

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55 Section 588M(2).
56 Section 596AC(2).
57 Section 598(2). See also definition of "eligible applicant" in s. 9.
58 Section 588FH.
59 (1843) 67 ER 189.
60 Sections 588R, 588S, 588T and 588U.
61 Sections 596AF, 596AG, 596AH and 596AI.
62 See Division 269 of Schedule 1 to the Taxation Administration Act 1953.
63 See the Tax Laws Amendment (2012 Measures No. 2) Act 2012.

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

5.5.6 For example, in relation to contraventions of civil penalty provisions, ASIC may apply for a declaration of contravention, a pecuniary penalty order or a compensation order.[64] ASIC may also make an application to the Court against those guilty of fraud, negligence, default, breach of duty or breach of trust in relation to the company.[65]

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.[66]

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[67] (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 circulating security interest[68] 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))[69]; and

(d) for the ASIC - compensation equal to the loss or damage (ss 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).

In respect of a claim by the Commissioner of Taxation under section 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.

ASIC or the Director of Public Prosecutions may lay charges where a criminal offence is alleged. Remedies are generally fines and/or imprisonment.[70]

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 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.[71]

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.[72]

64 Under s. 1317J.
65 Section 598. See also definition of "eligible applicant" in s. 9.
66 Section 1313.
67 The liquidator must be suing in the name of the company.
68 Defined in section 51C.
69 Pursuant to ss. 596AF and 596AG.
70 A criminal court may also order a director to pay compensation to the company (section 588K). 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.
71 Section 475.
72 Section 530A.

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.[73]

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 Where ASIC believes that a person can give information relevant to a matter it is investigating or is to investigate, ASIC may require that person to attend an examination on oath or affirmation and give all reasonable assistance to ASIC[74]. ASIC may also require a person to produce specified books[75].

7.1.6 Finally, section 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.

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 Australian common law".[76]

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, and 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[77] (except for proceedings concerned with the falsity of such information or document).[78]

7.2.5 Similar rules apply in relation to examining a person about a corporation under section 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)).[79]

7.2.6 It is settled law in Australia that the privilege is not available to artificial entities such as corporations.[80]

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 section 588FF must be commenced before the later of three years after the relation-back day or 12 months after the first appointment of a liquidator in relation to the winding-up of the company or within such longer period as the court orders on an application by the liquidator within that period (s. 588FF(3)).

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

[73] Sections 596A and 596B.
[74] Section 19 of the Australian Securities and Investments Commission Act 2001.
[75] Section 33 of the Australian Securities and Investments Commission Act 2001.
[76] *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477.
[77] Section 1349.
[78] 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.
[79] Note that the protection does not apply in civil proceedings.
[80] See above, footnote 76. See also s. 1316A.

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 six years after the beginning of the winding-up (s. 588M(4)).

8.1.4 Actions against persons who breach section 596AB (agreements or transactions entered into to avoid employee entitlements) must be made within six 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 section 588V may only be commenced within six years after the beginning of the winding-up (s. 588W(2)).

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 six years after the contravention (s. 1317K).

8.1.7 Criminal proceedings may be instituted within five years after the act or omission said to constitute the alleged offence or at any later time with the consent of the Minister (s. 1316). Penalty notices for alleged contraventions of minor offences[81] 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.

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 (i.e. superior Court). Where the relevant section of the Corporations Act refers to court with a small "c", that court means any court.[82]

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 New South Wales a party has 28 days after the date of a Supreme Court decision to file a Notice of Appeal, subject to leave requirements, unless the Court of Appeal orders otherwise.[83]

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 file and serve a notice of appeal.[84]

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.[85]

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 The provisions dealing with transactions in the "twilight" period[86] apply to both foreign and domestic companies.[87]

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), 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 that 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.

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81 See above, footnote 70.
82 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.
83 Rule 51.16 of the Uniform Civil Procedure Rules 2005.
84 Rule 36.03 of the Federal Court Rules 2011
85 Section 206G of the Corporations Act.
86 This encompasses all the provisions of the Corporations Act considered above, but may not necessarily include relevant provisions from other legislation.
87 See definitions of "corporation" (s. 57A), "company" and "foreign company" (s. 9).

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):[88]

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

(b) conduct resulting in a pecuniary penalty or compensatory order;[89]

(c) conduct not in good faith;

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

(e) conduct involving improper use of position or information.[90]

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)).[91] 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 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 Overview

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*[92] 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.[93] 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.[94]

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 circulating security interest[95] which is created on the property of the company during 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 void against the company's liquidator unless the company was solvent immediately after the circulating security interest was created (ss. 588FJ(1) and (3)).

[88] Sections 199A and 199B of the Corporations Act.
[89] Such penalties and orders are provided for in sections 1317G and 1317H of the Corporations Act.
[90] Such conduct is prohibited by sections 182 and 183 of the Corporations Act.
[91] See also s. 212(2)(c)(ii).
[92] (1966) 115 CLR 666.
[93] 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)).
[94] *Sandell v Porter* (1966) 115 CLR 666, per Berwick CJ at 370. See also *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.
[95] As defined in section 51C and includes a floating charge.

11.2.3 However, section 588FJ(2) provides that any such circulating security interest 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 circulating security interest was created and as consideration for the circulating security interest;

(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 circulating security interest 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 circulating security interest; 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 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, but only before the expiry of three months from the due date of those tax debts.

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 one to two years.

1.4 Summary of insolvency procedures for corporations

1.4.1 Voluntary administration

If, in the opinion of its directors, a company is insolvent (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);

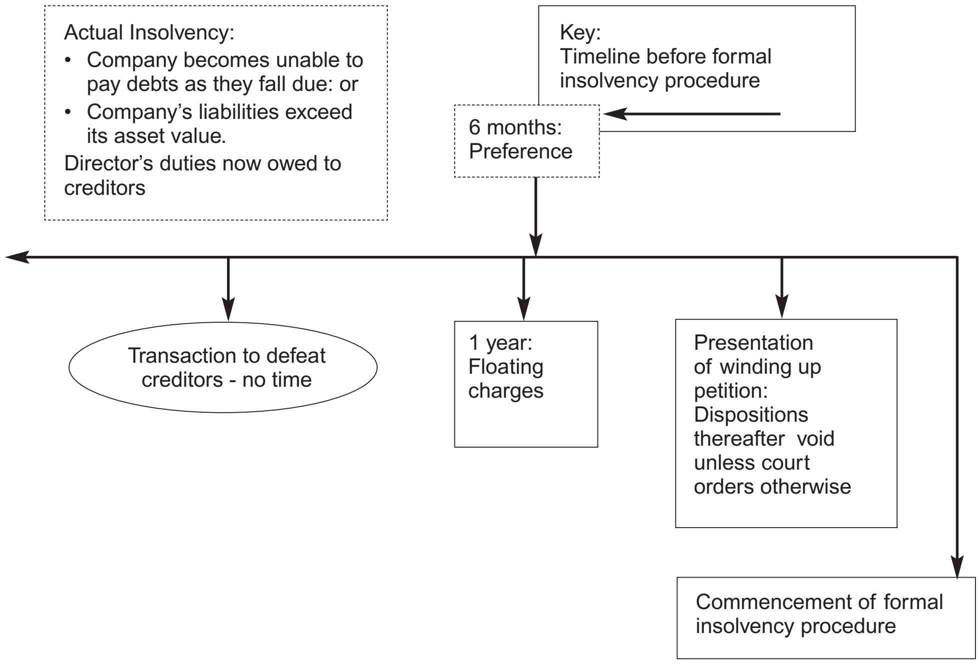
(c) transactions at an undervalue (eg. guarantees) - two years (s36A,) Conveyancing Act 1993;

(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.

1.1.5



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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

(iii) that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose;

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

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

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[2] Section 246 Companies Act 1981.

(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.

(vi) 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.

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

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, -

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

(b) 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

(c) 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]

According to section 243 (1) of the Companies Act, 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 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

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[3] Section 245 Companies Act 1981
[4] Section 243(1) Companies Act

(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 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 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 over-ride 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:

[5] Section 244 Companies Act 1981.

(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.

In such circumstances:

(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 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 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 bylaws. 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;

    (i) he acted reasonably; and

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

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6 Section 98B (2) Companies Act 1981.
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.
11 Section 98B(2) Companies Act 1981.
12 Section 98B(3) Companies Act 1981.
13 Section 98B(4) Companies Act 1981

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.

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 De facto directors

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.

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.

[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.

[15] Section 98B Companies Act 1981.

(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;

(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.

4.1 Summary of heads of challenge

4.1.1 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) 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

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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.
[18] Section 237 Companies Act 1981.

(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.

What is a preference?

4.3.2 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

4.3.3 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.

4.4 Avoidance of floating charges for past value[20]

4.4.1 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

4.4.2 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.

4.4.3 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

4.4.4 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.

[19] Section 239 Companies Act 1981.
[20] Section 240 Companies Act 1981.

4.5 Disclaimer of onerous property[21]

4.5.1 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.

4.5.2 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.

4.5.3 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).

4.5.4 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.

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

4.6.1 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.

4.6.2 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

4.7 Registration of charges

4.7.1 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 change against the company or a liquidator.

QUESTION 5

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 on 5.3.2.

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 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 the course of winding-up - section 243

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

(d) Fraudulent trading - section 246 of Companies Act

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[21] Section 166 Companies Act 1981.

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

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 officeholder, 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 by	The director may be ordered to compensate the company for all loss and damage caused breach of his fiduciary duty.
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;

Offence	Remedy available
	(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; (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. 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.

7.2.2 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.

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

[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.

[24] 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.

(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?

(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]

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 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:

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[25] United Kingdom Statutory Instrument SI 1968 No. 182, Bermuda Constitution Order 1968.
[26] Section 278 of the Companies Act 1981.
[27] Section 11 of the Limitation Act 1984.
[28] Section 4 and section 7 of the Limitation Act 1984.
[29] Section 33 of the Limitation Act 1984.
[30] Section 12 of the Court of Appeal Act 1964
[31] Section 2, Appeals Act 1911.

(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 judicial precedent supporting the proposition that the provisions of the Companies Act 1981 pertaining to insolvent liquidation may also apply to an overseas company which carries on business in Bermuda through an agent by reason of the External Companies (Jurisdiction in Actions) Act 1885.[33]

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

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 wilful 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 to 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 overturning 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 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.

[32] Section 4(1) and section 4((1A) of the Companies Act 1981.

[33] Re *Kingate Global Fund Limited* [2010] Bda LR 67.

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

LIQUIDATION PROCEDURES

Three separate liquidation procedures are available. These are:

(A) Voluntary winding-up;

(B) Winding-up under the supervision of the court (also known as compulsory winding-up);

(C) 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 that 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.

(C) 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 Under Brazilian law, the insolvency of merchants and business companies is regulated by Law 11,101/2005 (the Insolvency Law), which provides for bankruptcy and judicial and extra-judicial (expedited) restructuring proceedings.

Where a court declares a merchant debtor to be bankrupt, it shall establish the date of the bankruptcy, upon which the insolvency period will be deemed to have commenced.

1.2 This date will be retroactive from the date of the protest of an enforcement title, or the filing of a judicial restructuring request or a bankruptcy request. This legal bankruptcy time frame (the suspect period) is established by the court, but it may not extend more than 90 days before the company becomes insolvent as described above. Some acts are deemed to be ineffective if practised within this time frame, even when performed in good faith.

In addition, any gratuitous acts (such as donations or debt pardons) or renunciations of inheritance performed during the two years before the declaration of bankruptcy, are held to be ineffective, regardless of whether there is proof that they were performed with the intention of defrauding creditors.

Any fraudulent transaction entered into by and between the debtor and third parties with the intention to harm the rights of creditors or cause damage to the estate is voidable. Brazilian law does not establish a retroactive time frame for the avoidance of these acts, although the revocatory action (*actio pauliana*) must be filed within three years from the date on which the debtor was declared bankrupt.

1.3 There is no special liability system for the management of the company during the suspect, or twilight, period.

1.4 It must be stressed that consumers and non-business entities are subject to the civil insolvency proceeding regulated by the Code of Civil Procedure (Law 5,869/1973). There are no specific avoidability rules in civil insolvency proceedings, nor is there a twilight period. In this context, the general rules contained in the Civil Code governing fraud against creditors are applicable.

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:

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 differences, if any, will be available in relation to each offense?

2.1 There is no special liability system involving the bankruptcy twilight period. The personal liability of an officer or director of a bankrupt company will be determined by way of an action brought before the court administering the company's bankruptcy.

2.2 Under Brazilian law, officers and directors are not personally liable for obligations incurred in the corporation's name by virtue of administrative acts performed in the normal course of business. There are, however, exceptions to this general rule[1]. Corporate officers and directors are personally liable when:

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

(b) they violate the law or act in an ultra vires (beyond the scope of their powers) manner, whether or not they do so in a negligent or fraudulent manner.

Under (a), if officers or directors are acting within the scope of their powers, they can only be held liable if it is proven that they have acted recklessly, negligently, incompetently or fraudulently. Under (b), however, officers and directors will be held strictly liable for ultra vires acts.

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

In Brazil, piercing of the corporate veil has been upheld in cases of irregular dissolutions of entities; improper intermingling of corporate assets involving a sole shareholder or administrator; undertaking activities which are incongruent with the company's corporate purposes; and the absolute power of one partner who is involved in 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.[2]

A director is not responsible for the illegal acts of other directors, unless he conspires with them or is deemed negligent in discovering their illegal acts, or, having knowledge of the wrongdoing, fails to attempt to stop such acts. On the other hand, directors are jointly and severally liable for 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 normal functioning of the company, may result in joint and several liability of the 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 a general rule: negative facts, resulting from acts of omission or failure to act, even if not the result of joint deliberation, will result in joint and several liability for 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. Therefore, either negative or positive facts resulting from joint deliberations can give rise to joint and several liability, except for those individuals who expressly object.

For publicly traded companies, directors will only be liable for damages resulting from a failure to perform their individual duties in accordance with the company by-laws. The Brazilian Securities and Exchange Commission (*"Comissão de Valores Mobiliários"* – CVM) has the authority to impose administrative penalties by means of administrative hearings. These penalties include warnings, fines and the suspension or disqualification of directors. The Brazilian Central Bank has a similar authority to issue warnings and to impose fines, suspensions and disqualifications with respect to the directors of financial institutions.

In other circumstances, the corporate veil may be pierced and an affiliate may be deemed responsible for the debts of the debtor, without suffering all the consequences of bankruptcy. For example, a court may order a parent company responsible for the payment of damages incurred by its failed subsidiary without the parent company itself declaring bankruptcy.

Upon declaration of bankruptcy, the judicial administrator appointed by the court must present a report on the causes and circumstances that led to the state of bankruptcy, in which he shall indicate the civil and criminal liability of the parties involved. Should there be any indication of criminal liability by any of the parties involved in the proceedings, the Public Attorney's Office shall be notified. The Public Attorney's Office has the authority to bring criminal charges against the bankrupt's directors and/or officers and to represent the public interest as a whole.

The Bankruptcy Law states that a bankrupt corporation's directors and officers will be identified for criminal purposes. Chief among the criminal acts related to bankruptcies is the practice of fraudulent acts against creditors, with the purpose of obtaining an illegal advantage for himself or for third parties.

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[1] Articles 1,015, 1,016 and 1,017 of Law 10,406/2002 (Civil Code) and Article 158 of Law 6,404/1976 (Corporation Law).

[2] Article 158, Sections 1-5.

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 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 debtor. The debtor itself is considered liable for any damages caused by these third parties. However, the debtor 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.[3] 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 diligence and accuracy in their services.

The 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 accordingly in order to exonerate themselves from liability.

Under the Brazilian Criminal Code, criminal acts of corporate fiduciaries are punishable by imprisonment and/or fines. The punishable acts include:

(a) making false representations as to the financial status of the company, or to fraudulently hide facts related to that status, in a report, balance sheet, communication 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 authorisation; and

(d) obtaining the approval of minutes or opinions through collusion with the shareholders.

In addition to the Criminal 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 criminally 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.

The Insolvency Law provides that any person may be found criminally liable for hiding or diverting assets from the bankrupt estate or making false statements or claims within the proceedings. The law further provides that the judge, the public attorney, the trustee, the expert, the bailiff and the auctioneer may be held criminally liable for directly or indirectly purchasing assets from the estate, or entering into any profit-orientated speculation.

Lender's liabilities are not yet an important factor in Brazil. Initial cases are being argued in court, but generally speaking financial institutions have not been found liable for the potential damage underlying these claims. Reckless lending, as the basis to indemnify other creditors, has also not yet been recognised by statutory legislation. Case law is still not developed in this area.

QUESTION 4

4. Counterparts 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?

[3] Article 32 of Law 8,906/1994.

4.1 The commencement of a bankruptcy proceeding against a debtor does not include its guarantors, joint co-debtors or surety guarantors. Therefore, while the bankruptcy causes the acceleration of the maturity of the debts of the bankrupt party, and those of any joint shareholder of the company, it does not automatically entail the bankruptcy of its solvent co-debtors and guarantors. Additionally, the termination of collateral agreements may be prevented in circumstances where the judicial administrator considers the continuation of the agreement necessary and in the interest of the creditors.

4.2 Certain acts, performed by the bankrupt party before the bankruptcy, are deemed ineffective, whether or not the other party involved was aware of the impending bankruptcy and whether or not the transaction was performed with the intent to defraud.[4] The following acts are considered to be ineffective:

(a) any payment of debts not yet due within the twilight period;

(b) any payment made within the twilight period, of debts already due and enforceable, in a way not provided for under the underlying agreement;

(c) the grant of a security interest, including a lien, within the twilight period, in respect of a debt incurred previously;

(d) any act performed free of charge during the two years preceding the decree of bankruptcy;

(e) waiver of inheritance or legacy during the two years preceding the decree of bankruptcy;

(f) sale or transfer of an establishment without the express consent of or payment to all creditors existing at the time, when insufficient assets remain with the debtor to settle his liabilities, unless within 30 days there is no opposition by creditors after being duly notified, either judicially or by an officer of the deeds and documents registry; and

(g) registration of security interests and of property transferred inter vivos, for consideration or free of charge, or a restriction on real property made after the decree of bankruptcy, unless there was a previous restriction.

The ineffectiveness of such acts may be declared by the court by his own initiative or alleged in defense or claimed under a specific action during the proceedings.

The court may review and declare void, upon request of any creditor, the judicial administrator or the Public Attorney's Office, by means of a revocatory action, any act or contract performed or entered into with intent to defraud or cause damage to the debtor company.

4.3 Any acts that are performed in connection with the bankrupt estate with the intent to harm creditors, as long as there is evidence of the involvement of both the debtor and the third party in the attempt to defraud, are subject to revocation.

If a transaction is declared void or ineffective, the parties are returned to the state prior to the contracting. In such a scenario, the assets involved must be restored to the bankrupt estate whenever possible. As an alternative, an indemnity, corresponding to the market value plus damages, must be paid. The third party which acted in good faith will have a right of restitution to any assets or values delivered to the debtor and will have a claim for losses and damages against the bankrupt party and its guarantors.

The judicial administrator, the Public Attorney's Office or any of the creditors are entitled to file for the revocation of any act within three years of the court decision which declares the bankruptcy of the debtor.[5] The revocation action may be filed:

(a) against all those who took part in the act, or which, as a consequence thereof, were paid, given guarantees, or benefited;

(b) against acquiring third parties; and

(c) against the heirs or legatees of the persons mentioned in (a) and (b).

QUESTION 5

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 in an attempt to recoup its losses.[6]

5.2 The Insolvency Law provides that any creditor, the Public Attorney's Office and the judicial administrator can file suit to void fraudulent transactions. The court may declare the ineffectiveness of any act by its own initiative or upon the request of any interested party.[7]

[4] Article 129 of Law 11,101/2005.
[5] Article 132 of Law 11,101/2005.
[6] Article 159 of Law 6,404/1976.
[7] Article 129 of Law 11,101/2005.

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 Certain acts, described by law, are considered ineffective by the court, by its own initiative or at the request of any interested party, regardless of the contracting parties' knowledge of the debtor's economic condition, or the existence or absence of any intent to defraud creditors. These ineffective acts are described in item 4.2.

In addition, the Insolvency Law provides that any acts performed with the intent to harm creditors, as long as there is evidence of the involvement of both the debtor and the third party in the attempt to defraud, may be revoked.[8] The revocation action is described in item 4.3.

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 (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 In judicial restructuring and bankruptcy proceedings, the debtor, its administrators or its creditors, may be called to provide the judicial administrator with any requested information. If the debtor, its administrators or its creditors refuse to cooperate, they may be called before the court in order to provide the information requested by the judicial administrator.

The Insolvency 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 destroys obligatory accounting books, thus hindering the progress of the bankruptcy proceedings, in order to obtain an unfair advantage, he may be held criminally liable.

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 judicial administrator, the Public Attorney's Office or any of the creditors are entitled to file for the revocation of any fraudulent act within three years of the court decision which declares the bankruptcy of the debtor.[9]

8.2 The statute of limitation for filing a civil liability action against limited liability shareholders and directors or other persons involved with the entity's administration is two years from the date of the court decision which terminates the insolvency proceeding.[10]

For criminal liability in connection with bankruptcy crimes, the statute of limitations follows the rules contained in the Criminal Code.[11]

8.3 Any interlocutory order issued in the course of the proceeding may be challenged by a bill of review within ten days of the date in which such order was issued.[12]

A lower court final decision may be challenged by an appeal, which must be filed within 15 days from the date on which such final decision was rendered and, in most cases, it will suspend the enforceability of the decision until the appellate court rules on the appeal.[13]

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8 Article 130 of Law 11,101/2005.
9 Article 132 of Law 11,101/2005.
10 Article 82, Section 1, of Law 11,101/2005.
11 Article 182 of Law 11,101/2005.
12 Article 522 of the Code of Civil Procedure.
13 Article 513 of the Code of Civil Procedure.

For an ordinary suit, especially when contested, it can take up to two or three years before a judgment is granted, and the judgment may still be subject to appeal. An enforcement action will depend on the facts of the specific case and the speed with which the debtor's assets can be identified for attachment. Any bank account held by the debtor may be seized by the court in an enforcement action.

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. Foreign corporations 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. Also, foreign corporations may be represented by an attorney domiciled in Brazil, provided that a power-of-attorney is duly executed.

Jurisdiction will be based on the principal place of business of a company (*principal estabelecimento*).[14] If a debtor has its principal place of business in Brazil, a local court will have jurisdiction and the legal ramifications of Brazilian insolvency proceedings will be applicable to all of the debtor's assets. 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.

The Insolvency Law provides that the presence of a local branch of a foreign business within Brazil will be sufficient to grant bankruptcy jurisdiction to a local Brazilian court. For these purposes, a branch office will be treated like any Brazilian subsidiary or legal entity.

The debtor under a judicial restructuring or a bankruptcy proceeding, and by extension, its officers and directors, insofar as they relate to the insolvency proceeding, fall under the jurisdiction of the state civil court in the region where the debtor's main establishment 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 (*carta precatória*), if they reside in Brazil, or by a letter rogatory (*carta rogatória*) if they reside abroad.

9.2 In cases in which a foreign judgment is to be recognised in Brazil, certain conditions must be met. These conditions are as follows:

(a) the judgment was handed down by a court of competent personal and subject matter jurisdiction;

(b) there was proper service on the defendant;

(c) the judgment is final in the awarding country and is not subject to any further analysis or appeal;

(d) Brazil's sovereignty, public policy or morality must not be offended by the judgment; and

(e) the judgment has been consularised by a competent Brazilian authority and then translated into Portuguese by a certified translator in Brazil.

The most frequently contested foreign judgment recognition requirement is the need for proper service on a defendant domiciled in Brazil. Because Brazil is not a member of the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters of 1965, service of process must be in accordance with Brazilian law. Therefore, the appropriate method for properly serving process on an individual domiciled in Brazil is via a letter rogatory (Brazil is a member of the Inter-American Convention on Letters Rogatory, which was signed in Panama on January 30, 1975, and ratified by Brazil on December 27, 1995).

In instances where Brazilian law claims the exclusive jurisdiction of a party or subject matter, the Brazilian courts will not recognise a foreign judgment. If the debtor has its principal place of business in Brazil, a Brazilian court will not recognise a foreign judgment. Brazilian law has exclusive jurisdiction over these entities pursuant to Article 3 of the Bankruptcy Law, and the Superior Court of Justice will not recognise any foreign judgment.

Additionally, real estate assets are considered to be within the exclusive jurisdiction of the Brazilian courts. These exclusions from the recognition of foreign judgments, although not uncommon in other jurisdictions, limit further any extension of a universal insolvency approach in Brazil. With respect to these parties and assets, creditors must bring their action in Brazil in order to protect their rights.

[14] Article 3 of Law 11,101/2005.

QUESTION 10

10. Insurance

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

10.1 Director's and Officer's (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 in respect of that 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 bankruptcy or restructuring proceeding.

D&O liability policies in Brazil are usually issued for a one-year term under a "claims made basis" (ie, 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 shareholders 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 (eg, 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 the above terms and conditions.

QUESTION 11

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

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]

1.1.1 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. However, directors and officers have ongoing liabilities under companion remedial statutes for unemployment contributions and pension contributions, as well as environmental liabilities where the corporation cannot satisfy claims.

1.1.2 An insolvent person is defined in the Bankruptcy & Insolvency Act (Canada), R.S.C. 1985, c. C-44 (BIA) as a person who is not bankrupt, who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under the BIA 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]

1.1.3 In a restructuring context under the Companies' Creditors Arrangement Act (Canada), R.S.C. 1985, c. C-36 (CCAA), the BIA test set out in (a) above is given a purposive interpretation so that it is acceptable to consider whether, at the time of filing, there is a reasonably foreseeable expectation that there is a looming liquidity condition or crisis that will result in the debtor running out of cash to pay its debts as they generally become due in the future without the benefit of a court-ordered stay of proceedings, ancillary protection and procedures.[3]

1.1.4 As a general rule, the "twilight" period terminates when formal insolvency procedures are commenced.

1.1.5 The definition of "corporation" in the BIA includes any company or legal person incorporated by or under an Act of Parliament or the legislature 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 or an income trust, 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.[4] 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] This paper makes reference to federal and provincial statutes. The provincial statutes cited are from Ontario, however, each provincial jurisdiction has comparable legislation.
[2] BIA, s. 2(1).
[3] *Re Stelco Inc.* (2004), 48 C.B.R. (4th) 299, leave to appeal dismissed [2004] O.J. No. 1903 (Ont. C.A.), leave to appeal dismissed [2004] S.C.C.A. No. 336 (S.C.C.).
[4] BIA, s. 2(1).

1.1.6 The review periods under the BIA, also applicable under the CCAA, revolve around the phrase "date of the initial bankruptcy event" which is used to establish the effective date of insolvency for the purpose of certain transactions. In the case of a voluntary assignment, the date of the initial bankruptcy event is the date of the filing or the making of the assignment. In the case of a proposal, which is a form of restructuring under the BIA, the date of initial bankruptcy event is the date a notice of intention or a proposal is filed. Where there has been an application for a bankruptcy order, the date of the initial bankruptcy event is the date of the filing of the application. 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. Finally, where proceedings have been commenced under the CCAA, the filing date of those proceedings is the relevant date.

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 is a framework under the BIA for challenging transactions that may diminish the value of an insolvent debtor's estate, reducing the amount of money available for distribution to the creditors. The BIA framework applies with necessary modifications under the CCAA.[5] 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.

Transfers at undervalue

1.3.2 A transfer at undervalue is a transaction in which the consideration received by a person is conspicuously less than the fair market value of the property or services sold or disposed of by the person in the transaction. A transfer at undervalue under the BIA may be void as against the trustee or as against the debtor company under the CCAA (on application by the CCAA monitor) where a bankrupt or CCAA debtor has been involved in:

(a) an arm's length transaction during the period commencing one year before the date of the initial bankruptcy event and the debtor was insolvent at the time of the transfer, or rendered insolvent by it, and the debtor intended to defeat the interests of creditors, or

(b) a non-arm's length transaction during the period commencing one year before the initial bankruptcy event, or

(c) a non-arm's length transaction within one to five years before the date of the initial bankruptcy event if the debtor was insolvent at the time of the transfer, or rendered insolvent by it, and intended to defeat the interests of creditors. (See discussion of non-arm's length parties below).

The trustee or CCAA monitor is entitled to inquire into transfers at undervalue for the purpose of determining whether a bankrupt or CCAA debtor has paid or received, as the case may be, fair market value for the property involved in the transaction. The trustee or CCAA monitor is authorized to apply to the court so that the court may determine as a question of fact whether the transaction was a transfer at undervalue and whether or not the other party was at arm's length with the debtor in relation to the transfer.

If the consideration given or received is conspicuously greater than or less than fair market value, the court may grant judgment in favour of the trustee or debtor company (on application by the CCAA monitor) 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 or debtor company may recover from other parties to the transaction and/or any other person being privy to the transaction.[6]

Preferences

1.3.3 A preference occurs when an insolvent debtor pays one or more creditors at the expense of other creditors. Preferences under the BIA and the CCAA in favour of a creditor may also be void as against the trustee in bankruptcy or debtor company. The review period is three months before the initial bankruptcy event and ending on the date of bankruptcy or the CCAA filing, as applicable, but such period is extended to one year in the event of a transaction in favour of someone non-arm's length to the insolvent person.[7] There is no requirement to prove that the debtor intended to prefer the non-arm's length creditor where the transfer had the effect of preferring one creditor over another. In the case of an arm's length transaction, a preference will be presumed where, in the absence of evidence to the contrary, the transfer had the effect of preferring one creditor over another.[8]

Non-arm's length parties

1.3.4 For the purposes of transactions at undervalue and preferences, related persons are, in the absence of evidence to the contrary, deemed not to deal with each other at arm's length.[9]

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5 CCAA, s. 36.1.

6 BIA, s. 96. Section 36.1 of the CCAA adopts the BIA framework for challenging transfers at under value and preferences with necessary modifications (e.g., references to "trustee" in the BIA are to be read as references to "monitor"). There appears to be a drafting oversight in the adoption of the BIA framework in that references to be made to monitor are more appropriately references to the debtor company.

7 BIA, s. 95(1); CCAA, s. 36.1.

8 BIA, s. 95(1)(b); CCAA, s. 36.1.

9 BIA, s. 4(5).

1.3.5 For the purposes of the BIA and CCAA, 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[10]

1.3.6 For the purposes of the BIA and CCAA, “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;

(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.[11]

Payment of dividends while insolvent

1.3.7 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 one year before the initial bankruptcy event and ending on the date of bankruptcy or the date of the CCAA filing, as applicable, the court may, on application by the trustee under the BIA or CCAA monitor, inquire into the transaction to ascertain whether it occurred at a time when the corporation was insolvent or whether it rendered the corporation insolvent.[12] If the transaction occurred at such a time, the court may give judgment to the trustee or in favour of the CCAA debtor, as applicable, 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.[13]

1.3.8 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.[14]

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[10] BIA, s. 4(2); CCAA, s. 2(2).
[11] BIA, s. 4(3); CCAA, s. 2(2).
[12] BIA, s. 101(1). Section 36.1 of the CCAA incorporates and adopts the provisions of section 101 of the BIA with necessary modifications.
[13] BIA, s. 101(2); CCAA, s. 36.1.
[14] BIA, s. 101(2); CCAA, s. 36.1.

1.3.9 A director is protected from the provisions of this section if the director protested against the payment of the dividend or the redemption or purchase for the cancellation of shares of the stock of the corporation. Where certain statutory requirements are satisfied, the court may give judgment to the trustee or in favour of a CCAA debtor, as applicable, 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.[15]

Provincial legislation addressing certain transactions

1.3.10 A trustee in bankruptcy can also resort to statutes other than the BIA. The Ontario Fraudulent Conveyances Act[16] 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 generally two years from the time when the plaintiff first became aware of the fraudulent conveyance.[17] All Canadian provinces have similar legislation.

1.3.11 A sale in bulk is voidable in Ontario unless the buyer has complied with the provisions of the Bulk Sales Act.[18] 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. Most legislation on bulk sales has been repealed in the rest of Canada.

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) non-arm's length; or (b) dealing at arm's length with the bankrupt or CCAA debtor. For example, if the parties are not dealing with each other at arm's length, then the period in which to review preferences is extended from three months to one year. (See discussion of non-arm's length parties in section 1.3 above).

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 incurred in their capacity as such. However, a proposal under the BIA or a proposed plan of arrangement under the 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.[19]

1.5.2 The legislation does not address the compromise of claims against officers. However, cases have held that if the plan of arrangement contains or, at least for the corporation's officers, is approved by the various constituencies, it should be viewed as a contract between the debtor and its creditors and the court should not interfere with it.[20]

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.

1.5.4 The Ontario Court of Appeal has held that the CCAA provides jurisdiction to release third parties in a plan of compromise or arrangement, including (although distasteful) from fraud, as long as there is a reasonable connection between the third party claim being compromised and the restructuring plan and the plan itself is fair and reasonable. Leave to appeal this decision to the Supreme Court of Canada was dismissed.[21] In a more recent Ontario case, the court held that the treatment of third party releases applies equally in the context of BIA proposal proceedings as in CCAA proceedings.[22]

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?;

[15] BIA, s. 101(2.2).
[16] R.S.O. 1990, c. F. 29.
[17] The Ontario Court of Appeal in *Re Edwards* (2011), 336 D.L.R. (4th) 719, held that general limitation periods in provincial statutes apply to bankruptcy proceedings.
[18] R.S.O. 1990, c. B-14 (the "BSA").
[19] BIA, s. 50(13) and (14); CCAA, s. 5.1.
[20] *Re Canadian Airlines Corp.* (2000), 20 C.B.R. (4th) 1 (Alta. Q.B.) at 23.
[21] *Re Metcalfe & Mansfield Alternative Investments II Corp.*, 2008 ONCA 587, leave to appeal to the Supreme Court of Canada dismissed 2008 CanLII 46997 (SCC).
[22] *Re Kitchener Frame Ltd.* (2012), 86 C.B.R. (5th) 274 (Ont. S.C.).

(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 corporate law statutes. In performing their functions, directors are required to:

(a) act honestly and in good faith with a 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.

2.1.2 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 was considered by the Supreme Court of Canada in *Peoples Department Stores Inc. v. Wise* ("Peoples Department Stores").[23]

2.1.3 In Peoples Department Stores, the Supreme Court of Canada 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". 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 2.7 herein) available to them.

2.1.4 After the Peoples Department Stores decision, the duty of care provisions of the Ontario Business Corporations Act (OBCA) were amended to clarify that directors only owe their duty of care to the corporation.[24] Therefore, in Ontario, directors will only be liable for breach of fiduciary duty where an action is commenced by the corporation or where a complainant is granted leave by a court to bring a derivative action in the name of the corporation. No other Canadian legislation has been amended to relieve directors of this liability.

2.1.5 Where a director breaches his or her duties to the corporation, attempts by a shareholder or creditor to assert a derivative or oppression action against a director may raise issues of standing. Where a company is nearing insolvency, a director's breach of his or her duties to the corporation may result in a traceable injury to both shareholders and creditors alike. Courts have struggled with balancing the interests of shareholders and creditors when companies are operating in this "twilight period". In these circumstances, it appears that both shareholders and creditors might have standing to assert derivative or oppression claims against directors for breach of their duties to the corporation. (See discussion of oppression and derivative actions in section 2.7 below).

2.2 General bankruptcy offences under the BIA

2.2.1 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.[25]

2.2.2 A bankrupt commits a bankruptcy offence where it:

(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 one 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;

(e) after or within one 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 one 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

[23] (2004), 244 D.L.R. (4th) 564 (S.C.C.).
[24] R.S.O. 1990, c. B16, s. 132(5), as amended by Ministry of *Government Services Consumer Protection and Service Modernization Act*, 2006, S.O., 2006, c.34, in force August 1, 2007.
[25] BIA, s. 204.

(g) after or within one 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.[26]

2.2.3 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 2.2.2 (a) – (g); and

(e) absence of an intention to defraud or conceal amounts to a defence.

2.2.4 The acts set out in section 2.2.2 herein are criminal offences in which the government 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.

2.3 Failure to keep proper books of account

2.3.1 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.[27]

2.3.2 If 2.3.1 above is satisfied, and the impugned transaction occurred within the period beginning two years before the initial bankruptcy event and ending on the date of bankruptcy, then section 2.2.3 (a) to (c) and (e) above apply.

2.4 Unlawful transactions

2.4.1 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.[28]

2.4.2 Where 2.4.1 above is satisfied:

(a) liability is criminal (although unlawful transactions are also actionable civilly);

(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 one 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) the offence applies after the corporation becomes bankrupt; and

(e) absence of intent to obtain a benefit or advantage amounts to a defence.

2.5 Declaration of dividends

2.5.1 Where the court finds that either the bankrupt corporation or CCAA debtor 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.[29]

2.5.2 Where 2.5.1 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;

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[26] BIA, s. 198(1).
[27] BIA, s. 200(1).
[28] BIA, s. 201(3).
[29] BIA, s. 101(1); CCAA, s. 36.1. See also *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 42 (CBCA) and OBCA, s. 38(3). (Note: Provinces other than Ontario have their own *Business Corporations Act*).

(c) the liability will attach to the directors jointly and severally;

(d) the declaration of dividends must have occurred within the one 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:

(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.[30]

2.6 Liability for debts due to employees

2.6.1 The Wage Earner Protection Program Act (WEPPA)[31] and related Regulations provide for the timely payment of wages and vacation pay (but not severance or termination pay) owed to eligible workers up to an amount equalling the greater of four weeks' maximum insurable earnings under the Employment Insurance Act and $3,000 per employee. An eligible worker is one whose employment was terminated as a result of the former employer filing for bankruptcy or becoming subject to a receivership and who is owed wages and vacation pay earned during the six months immediately prior to the date of bankruptcy/receivership. The payments will be made by the government which is then subrogated to the employees' rights and may maintain an action against the bankrupt, insolvent employer or directors in the name of the employee or in the name of the government. Directors do not have personal liability under WEPPA.

2.6.2 According to corporate statutes such as the CBCA, and provincial employment standards legislation, 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.[32] This liability generally does not include personal liability for severance pay.[33] The directors are also liable for any vacation pay that accrued over a period of up to 12 months while they were directors.

2.6.3 With respect to the personal liability of directors for the wages and vacation pay set out above[34]:

(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 bankruptcy 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 bankruptcy 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 two years after ceasing to be a director.

2.7 Oppression and derivative actions

2.7.1 Even if a director does not breach his fiduciary duty, he may still be found to have acted "oppressively".

2.7.2 A complainant may apply to the court for an order under the oppression provisions of the CBCA (and comparable provincial corporate statutes) 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

(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.[35] A complainant is defined in some jurisdictions so as to include shareholders and creditors.

2.7.3 The courts have held that the oppression remedy is primarily aimed at redressing objectively reasonable expectations. The cases refer to the oppression remedy as an equitable remedy. The remedy seeks to ensure fairness – what is "just and equitable" – which is to be judged by the reasonable expectations of the stakeholders in the context and in regard to the relationships at play. Consequently, what is oppressive in one case, may not be so in another.[36]

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30 BIA, s. 101(2); CCAA, s. 36.1.
31 S.C. 2005, c. 47.
32 CBCA, s. 119. Each provincial jurisdiction has its own corporate statute that addresses personal liability for debts owing to employees.
33 In some provincial jurisdictions, there is liability for severance pay.
34 Note that the language in each provincial corporate statute varies in this regard.
35 CBCA, s. 241(2).
36 *BCE Inc. v. 1976 Debentureholders*, [2008] S.C.J. No. 37 at para. 59 (*BCE*).

2.7.4 In *BCE Inc. v. 1976 Debenture holders*,[37] the Supreme Court of Canada established a two-part test for determining whether an oppression claim will be successful:[38]

1. Does the evidence support the "reasonable expectation" the complainant asserts?

2. If so, does the evidence establish that the reasonable expectation was violated by conduct falling within the terms "oppression", "unfair prejudice" or "unfair disregard" of a relevant interest?[39]

2.7.5 The first prong of the BCE two prong test, involves an identification of the parties' reasonable expectations. There are two components to this prong of the test. First, the complainant must prove that they subjectively held an expectation concerning the corporation. Then, it must be determined whether the expectation that the complainant held was a reasonable one in the circumstances. Often the existence of the expectation can be expected to be proven simply by the complainant giving evidence of their belief or understanding and the reasons why they held that belief or understanding. Once an expectation has been proven to the requisite civil standard of proof, the question arises as to whether the expectation is a reasonable one.

2.7.6 If it is determined that the complainant held a reasonable expectation, then the analysis shifts to the second prong of the BCE two prong test. As set out above, the second prong focuses on an analysis of the fairness of the particular conduct identified that offends a subjectively held expectation that the court has found to be reasonable. This analysis is fact-specific and turns on the particular conduct and the particular expectations identified. In addition, the second prong is not reached if there is no subjectively held expectation proven or if the court determines that the expectation advanced is not a reasonable one.

2.7.7 Where a director has been found to have acted oppressively:

(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; and

(d) there is no specified period within which the relevant act must have been undertaken in order for liability to attach.

2.7.8 The courts have a wide discretion to fashion a remedy appropriate to the circumstances. The remedy to correct an oppressive act 'should be done with a scalpel, and not a battle axe', and the task of the court is to even the balance, not tip it in favour of the injured party.[40] The court may make an interim or final order which it thinks fit including an order:

(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;

(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.[41]

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[37] Ibid.

[38] While the decision in *BCE, supra* considered section 241 of the CBCA, the analysis is equally applicable to a consideration of the oppression remedy contained in section 248 of the OBCA, the language of which section is substantially similar to section 241 of the CBCA.

[39] *BCE supra*, at paras. 56, 68 and 95.

[40] *820099 Ontario Inc. v. Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 123 (Ont. Gen. Div.), affirmed (1991), 3 B.L.R. (2d) 113 (Ont. Div. Ct.).

[41] OBCA, s. 248(3); CBCA, s. 241(3).

2.8 General Liability under the BIA

Community service

2.8.1 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.[42]

Compensation for loss

2.8.2 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.[43]

2.9 Removal of directors

2.9.1 In addition to the actions that may attract liability for directors, the court has the authority to remove any director of a company undergoing a BIA or CCAA restructuring if satisfied that the director "is unreasonably impairing or is likely to unreasonably impair" the possibility of a viable proposal, arrangement or compromise, or "is likely to act inappropriately as a director in the circumstances".[44]

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 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.[45]

3.1.2 The BIA and the CCAA define "director" as including "a person occupying the position of director by whatever name called". This includes a person occupying the position of trustee of an income trust and may expand the ranks of persons who may be considered liable as directors, for example, to shareholders exercising powers under a unanimous shareholders' agreement.[46]

3.1.3 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 Transfers at undervalue[47]

3.2.1 If the debtor enters into a transaction for which no consideration is received by the debtor or for which the consideration received is conspicuously less than fair market value, then the court may give judgment to the trustee (or in favour of the CCAA debtor, in the case of a CCAA) 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 by the debtor and the fair market value of the property or services. The values on which the court makes any finding under this section are, in the absence of evidence to the contrary, the values stated by the trustee or CCAA monitor.

[42] BIA, s. 204.1.
[43] BIA, s. 204.3(1).
[44] BIA, s. 64(1); CCAA, s. 11.5(1).
[45] BIA, s. 204.
[46] BIA, s. 2(1); CCAA, s. 2(1).
[47] BIA, s. 96(1); CCAA, s. 36.1.

3.3 Preferences

3.3.1 A creditor of a corporation may be held liable when an insolvent corporation enters into a transaction with the creditor. If the creditor is an arm's length party and 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 (or CCAA debtor in the case of a CCAA). If the transfer had the effect of preferring an arm's length creditor, a preference will be presumed and, barring evidence to the contrary, the transaction will be void as against the trustee.[48] If the creditor is a non-arm's length party and the transfer had the effect of preferring the non-arm's length creditor, the transaction will be void as against the trustee (or CCAA debtor, in the case of a CCAA). The review period is three months before the initial bankruptcy event for an arm's length transaction with an extension to one year in the event of non-arm's length parties.[49] (See section 1.3 above regarding non-arm's length parties.)

3.3.2 From a practical standpoint, this means that the creditor of the corporation will be obligated to return to the trustee or CCAA debtor any consideration paid by the bankrupt or CCAA debtor in the transaction.

3.4 Liability of persons convicted of BIA Offences

3.4.1 See section 2.8.1 and 2.8.2.

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 counterparty seeking to protect a transaction from being attacked?

4.1 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.

4.1.1 The potential heads of challenge that may lead to transactions being set aside are transactions that:

(a) are at undervalue (i.e., conspicuously greater or less than fair market value);

(b) are preferences;

(c) involve dispositions of property after the commencement of bankruptcy proceedings;

(d) do not comply with provincial bulk sales legislation; or

(e) are oppressive.

4.1.2 Transactions within the time periods referred to below that take place in the ordinary course of business are generally protected.

4.2 Transfers at undervalue

4.2.1 A transfer at undervalue is the disposition of property or the provision of services for which no consideration is received by the debtor or for which the consideration received is conspicuously less than the fair market value of the consideration given by the debtor.

4.2.2 Where a debtor has entered into:

(a) a non-arm's length transfer at undervalue in the one year period before the initial bankruptcy event and ending on the date of bankruptcy;

(b) a non-arm's length transfer at undervalue in the one to five year period before the initial bankruptcy event and ending on the date of bankruptcy, where the bankrupt was insolvent or rendered insolvent by the transfer and the debtor intended to defeat or defraud its creditors; or

(c) an arm's length transfer at undervalue in the one year period before the initial bankruptcy event and ending on the date of bankruptcy, where the bankrupt was insolvent or if rendered insolvent by the transfer, and the debtor intended to defeat or defraud its creditors,

the court may, on the application of the trustee or CCAA monitor, inquire into whether the bankrupt or CCAA debtor gave or received fair market value in consideration for the property or services concerned in the transaction.[50]

4.2.3 It is a question of fact whether persons not related to one another within the meaning of the BIA and the CCAA were at the particular time dealing with each other at arm's length. Persons who are related within the meaning of the BIA are deemed not to deal with each other at arm's length.[51] (See discussion of non-arm's length parties in section 1.3 above).

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48 BIA, s. 95(2); CCAA, s. 36.1.
49 BIA, s. 95(1); CCAA, s. 36.1.
50 BIA, s. 96(1); CCAA, s. 36.1.
51 BIA, s. 4(2); CCAA, s. 2(2).

4.2.4 Where the court finds that the consideration given or received by the bankrupt in the transfer at undervalue was conspicuously greater or less than fair market value, the court may give judgment to the trustee (or CCAA debtor, in the case of a CCAA) against the other party to the transaction, or against any other person being privy to the transaction with the debtor, or against all those persons, for the difference between the actual consideration given or received by the bankrupt or CCAA debtor, and the fair market value as determined by the court, of the property or services concerned in the transaction.[52]

4.2.5 In making an application under this section, the trustee or CCAA monitor must state what in his or her opinion was the fair market value of the property or services concerned in the transaction and what in its opinion was the value of the actual consideration given or received by the bankrupt or CCAA debtor in the transaction.[53]

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 Preferences[54]

4.3.1 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 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.

4.3.2 If a payment or other disposition of property is made in circumstances that amount to a preference, the transaction remains valid unless or until it is set aside as a preference. The attack is made by a trustee in bankruptcy or CCAA monitor and the courts have the ability to declare the transaction to be fraudulent and void as against the trustee or CCAA debtor, as applicable. The review period and criteria vary depending on whether the preference is between arm's length parties or related parties. To attack a transaction as a preference, the trustee or CCAA monitor must prove that the conveyance was made to a creditor.

Arm's length preference

4.3.3 Every arm's length conveyance, transfer, charge etc. made by an insolvent person with a view to preferring a creditor within three months before the initial bankruptcy event and ending on the date the insolvent person becomes bankrupt, is fraudulent and void. In the case of an arm's length transfer, 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.[55]

Non-arm's length preference

4.3.4 Every transfer, conveyance, charge etc. made by an insolvent person to a non-arm's length creditor that has the effect of preferring a creditor within one year before the initial bankruptcy event and ending on the date the insolvent person becomes bankrupt or files for protection under the CCAA, will be fraudulent and void. There is no requirement to prove an intent to prefer existed. (See discussion of non-arm's length parties in section 1.3 above.)

Insolvency of debtor

4.3.5 Preference remedies can only be invoked if the transaction was effected by an "insolvent person". It is not necessary for the trustee, for example, 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. (See section 1.1.2 for the definition of insolvent person.)

Intention

4.3.6 Where the trustee or CCAA monitor is required to show that the transaction was entered into "with a view to giving that creditor a preference", only an intention on the part of the insolvent person is required. 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 insolvent person's conduct bears when reasonably construed and not that which, long after the event, he claims was his intention).

The presumption

4.3.7 In the case of an arm's length preference, the trustee or CCAA monitor is required to prove:

(a) that the transaction took place within three months 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.

4.3.8 If the trustee or CCAA monitor 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.[56]

52 BIA, s. 96(1); CCAA, s. 36.1.
53 BIA, s. 96(2); CCAA, s. 36.1.
54 BIA, s. 95 and 96; CCAA, s. 36.1.
55 BIA, s. 95; CCAA, s. 36.1.
56 BIA, s. 95(2); CCAA, s. 36.1.

Defences

4.3.9 The presumption can be rebutted by the defendant. 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 or monitor'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 one of two 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.

4.3.10 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, although these defences have not been tested under the current provisions, which were enacted in 2009.

4.4 Provincial legislation dealing with preferences

4.4.1 For conveyances that fall outside the time periods set out in the BIA, a trustee can resort to provincial property statutes dealing with preferences and fraudulent transfers.

Assignment and Preferences Act

4.4.2 The Ontario Assignments and Preferences Act[57] (APA) is ordinarily used by a trustee 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.[58] There are some important differences between the requirements under the BIA and those under the APA which, generally speaking, make it more difficult to prove a preference under the APA. There are also important differences between Ontario legislation and that of other provinces.

Fraudulent conveyances

4.4.3 The Ontario Fraudulent Conveyances Act[59] (FCA) does not conflict with the BIA and a trustee is entitled to make use of such legislation to supplement the rights and remedies provided by the BIA. Similarly, other assignment, preference and conveyance legislation has been found not to conflict.

4.4.4 The effect of the FCA 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.

4.4.5 The FCA 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. 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.

4.4.6 Under the FCA, 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.

4.4.7 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 needs only prove that the grantor had the intent to defeat, hinder, delay or defraud creditors.

4.4.8 If the court finds a transaction to be a fraudulent conveyance, the trustee or monitor will be entitled to a declaration that the conveyance is void as against him and that he is the owner of the debtor's interest in the property.

Defences

4.4.9 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.

4.4.10 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.

4.5 Protection of transaction made in good faith with bankrupt

4.5.1 The purpose of section 97(1) of the BIA[60] (as incorporated into the CCAA) is to deal with the effect of the relation back of the trustee's title in various sections of the BIA, such as the provisions dealing with preferences. Section 97(1) applies to payments, conveyances etc. that 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 transfer at undervalue, a preference or a fraudulent conveyance. The four headings are:

(a) a payment by the bankrupt to any of the bankrupt's creditors;

57 R.S.O. 1990, c. A.33.
58 APA, s. 4.
59 R.S.O. 1990, c. F.29.
60 Section 97(1) of the BIA; CCAA, s. 36.1.

(b) a payment or delivery to the bankrupt;

(c) a conveyance or transfer by the bankrupt for adequate valuable consideration; and

(d) a contract, dealing or transaction including any giving of security, by or with the bankrupt for adequate valuable consideration.

4.5.2 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 in so far as any claim for set-off is affected by the provisions of the BIA respecting frauds or preferences.

4.6 Bulk sales legislation

Purpose and application of BSA

4.6.1 Although bulk sales legislation has been repealed in every other Canadian jurisdiction, it is still applicable in Ontario.[61] 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.

4.6.2 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".[62] 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.[63]

4.6.3 A sale in bulk is voidable in Ontario unless the buyer has complied with the provisions of the BSA (as discussed below). An action or proceeding to set aside or have a sale in bulk declared void may be brought or taken by a "creditor" or trustee in bankruptcy of the seller within 6 months after the date in which the documents were filed under section 11 of the BSA.[64]

4.6.4 If a sale in bulk in Ontario 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.[65] 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.[66]

Disclosure of creditors

4.6.5 Section 4 of the BSA prohibits the purchaser from delivering a sum of more than 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 (a) is true and correct.

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.[67]

Compliance

4.6.6 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:

(a) 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

(b) 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

(c) 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

(d) the vendor may deliver to the buyer:

(i) 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

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61 BSA.
62 BSA, s.1.
63 *Ibid.*
64 A "creditor" is defined under the BSA as "any creditor, including an unsecured trade creditor and a secured trade creditor". In *Pizzolati & Chittaro Manufacturing Co. Ltd. v. May* [1972] 2 O.R. 606, 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.
65 BSA, s. 16(2).
66 BSA, s. 16.
67 BSA, s.5.

(ii) 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.[68] Duplicate originals of the documents mentioned in subparagraph 3(b)(iv) must be attached as exhibits to the affidavit.

4.6.7 If one of the conditions outlined in subparagraphs (a), (b) and (c) above is met, the buyer may deliver the proceeds of sale to the vendor. If the condition in subparagraph (d) 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.

4.6.8 In the decision of *National Trust Co. v. H&R Block Canada Inc.*,[69] 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.[70] 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 Supreme 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.

Completion of sale

4.6.9 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.[71] 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.[72]

4.6.10 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 (a) advantageous to the seller, and (b) will not impair the seller's ability to pay creditors in full.[73]

Limitation periods

4.6.11 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.

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 government prosecutor.

5.2 Criminal proceedings

5.2.1 The acts set out in section 2.2.2 herein are criminal offences in which the government 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 or CCAA monitor is the party who will bring proceedings in respect of transfers at undervalue, preferences, and fraudulent conveyances.

[68] BSA, s. 8.
[69] (2003), 44 C.B.R. (4th) 249 (S.C.C).
[70] [2003] 3 S.C.R. 160.
[71] BSA, s. 11.
[72] BSA, s. 19.
[73] BSA, s. 3.

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.[74] In some cases, the definition of complainant under the oppression remedy provisions explicitly includes creditors.[75]

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 was initially some uncertainty, but the case law has now clarified that a trustee in bankruptcy can assert an oppression claim 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.

The Ontario Court of Appeal has 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.[76]

5.4 Other

5.4.1 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.

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the offences identified in Question 2, Question 3 and Question 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 party harmed or to the trustee of the bankrupt estate an amount by way of satisfaction or compensation for the loss of or damage to property.
Transfers at Undervalue	Where the court finds that the debtor entered into a transaction and the consideration was conspicuously greater or less than the fair market value of the goods or services contracted for, then the court may order that the other party to the transaction pay to the trustee or CCAA debtor, as applicable, the difference between the consideration actually paid and the fair market value.
Preferences	Where the court holds that a transaction is a preference, then the transaction is void as against the trustee or CCAA debtor, as applicable. The trustee or CCAA debtor has the right to recover the property of the debtor given to the creditor as consideration for the transaction.
Declared dividends	Where a corporation that is bankrupt or in CCAA proceedings 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 or CCAA debtor, as applicable, against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest there on that has not been paid to the corporation.
Bulk sales legislation	A sale in bulk in Ontario 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 2.7.7.

[74] CBCA, s. 241 and 248; and OBCA, s. 245 and 248.
[75] For example, see the Alberta *Business Corporations Act* (although this remains subject to the exercise of the court's discretion) and the New Brunswick *Business Corporations Act*.
[76] *Olympia & York Developments Ltd. (Trustee of) v Olympia & York Realty Corp.* (2004), 46 C.B.R. (4th) 313 (Ont. C.A.).

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?

7.1 Obligation to co-operate with investigation into the 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 section 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 Sub sections 16(3) to 17(2) of the BIA set out the duties and powers of the trustee in obtaining possession of the property of the bankrupt. Section 158 of the BIA imposes the following duties on a bankrupt:

(a) informing the trustee of all property that is under their possession or control and delivering it to the trustee;

(b) delivering 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 their 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 one 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 five 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 their 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) informing the trustee of any material change in the bankrupt's financial situation;

(p) doing such acts or things in relation to the bankrupt's property in the distribution of the proceeds among their creditor as may be reasonably required for the trustee; and

(q) keeping the trustee advised at all times of the bankrupt's place of residence or address.[77]

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.[78] 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. Similar language protecting against self-incrimination is found in section 13 of the Charter of Rights and Freedoms.[79]

[77] BIA, s. 158.
[78] R.S.C., 1985, c. C-5.
[79] See Part I of the *Constitution Act, 1982*, 1982, c. 11 (U.K.), Schedule B.

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 Limitation periods: BIA

8.1.1 The limitation period for bringing an action against the director for any offence punishable by way of indictment is five years from the commission of the offence. If the offence is punishable by way of summary conviction, then the limitation period is three years from the commission of the offence.[80]

Limitation period for civil actions

8.1.2 In relation to any liabilities created by the BIA or in relation to breaches of directors' fiduciary duties, the limitation period, in several provinces is generally six years from the date on which the cause of action accrued.[81] In Ontario, Alberta, Saskatchewan and New Brunswick, the limitation period is generally two years from the date on which the claim was discovered, with an outside overall limitation period of 15 years in the case of Ontario.

8.2 Appeals

Is an appeal available from the decision of the lower courts?

8.2.1 The courts of appeal are given the power and jurisdiction to hear and determine appeals from the superior court sitting in bankruptcy. 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.[82]

8.2.2 An appeal from the decision of the Court of Appeal is only available with special leave granted by the Supreme Court of Canada. In the context of CCAA proceedings, considerable deference is given by appellate courts to judgments of the CCAA supervising judge.

8.2.3 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.[83]

An appeal is available in summary conviction matters as of right with no leave requirements.[84]

QUESTION 9

9. Foreign corporations

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

80 *Can. (A.G.) v. Hamelin* (1986), 62 C.B.R. (N.S.) 96 (Ont. S.C.).
81 See *Limitation Act* (British Columbia), *The Limitations of Actions Act* (Manitoba), *Limitation of Actions Act* (Nova Scotia), *Statute of Limitations* (PEI), *Limitations Act* (Newfoundland).
82 BIA, s. 193.
83 *Criminal Code* R.S.C. 1985 c. C-46, as amended, s. 675(1).
84 *Criminal Code*, s. 813(a).

9.1 Introduction

The legal provisions and procedures outlined in the BIA and CCAA generally apply to corporations that are authorized to carry on business in Canada or that have an office or assets in Canada wherever incorporated and any income trust. 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 and the CCAA, and are subject to provisions of the WURA.[85]

9.1.1 In general, all the provisions of the BIA and CCAA relating to the administration of a Canadian company apply equally to the administration of a foreign company.[86]

9.2 Jurisdiction of Canadian Courts

9.2.1 Canadian courts have a broad statutory and equitable authority.

9.2.2 With few minor differences, Canada has adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvencies, one of the objectives of which is to advance the fair and efficient administration of cross-border insolvencies.[87]

9.2.3 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 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.

9.2.4 The BIA and the CCAA have a specific scheme for administering debtor companies where proceedings outside of Canada have been commenced in respect of the debtor companies. Foreign proceedings are defined in the BIA and the CCAA as judicial or administrative proceedings in a jurisdiction outside of Canada dealing with creditors' collective interests generally under any law relating to bankruptcy or insolvency in which the property and affairs of a debtor are subject to control or supervision by a foreign court for the purposes of reorganization or liquidation.[88]

9.2.5 A foreign representative may apply to the Canadian court for recognition of a foreign proceeding in respect of which they are a foreign representative.[89] A foreign representative is defined in the BIA and the CCAA as a person or body, including one appointed on an interim basis, who is authorized, in a foreign proceeding in respect of a debtor, to administer or monitor the debtor's property or affairs for the purpose of reorganization or liquidation, as the case may be, to act as a representative in respect of the foreign proceeding.[90]

9.2.6 If the court is satisfied that an application for the recognition of a foreign proceeding relates to a foreign proceeding, as defined in the BIA or CCAA, and that the applicant is a foreign representative in respect of that foreign proceeding, the court will make an order recognizing the foreign proceeding. The court will be required to specify in the order whether the foreign proceeding is a foreign main proceeding or a foreign non-main proceeding.[91]

9.2.7 A foreign main proceeding is a foreign proceeding in a jurisdiction where the debtor has the centre of the debtor's main interests. In the absence of proof to the contrary, a debtor's registered office and, in the case of a debtor who is an individual, the debtor's ordinary place of residence are deemed to be the centre of the debtor's main interests.[92] A foreign non-main proceeding is a foreign proceeding, other than a foreign main proceeding.[93]

9.2.8 Recent case law has established three principal factors to be considered by courts where a foreign representative seeks to rebut the presumption that a debtor's centre of main interest is its registered office. The following factors, considered as a whole, tend to indicate whether the location in which the proceeding has been filed is the debtor's centre of main interest: (i) the location is readily ascertainable by creditors; (ii) the location is one in which the debtor's principal assets or operations are found; and (iii) the location is where the management of the debtor takes place.[94]

9.2.9 Where the court determines that a foreign proceeding is a foreign main proceeding, the court is required, on the making of an order recognizing the foreign proceeding, to grant certain enumerated relief subject to any terms and conditions it considers appropriate.[95] For other orders or where the court determines that a foreign proceeding is a foreign non-main proceeding, the court has the discretion to make any order it considers appropriate in the circumstances.[96]

9.2.10 Under the BIA and the CCAA, if an order is made recognizing a foreign proceeding, the foreign representative may commence and continue a proceeding for a bankruptcy order, interim receiver, proposal or restructuring 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.[97]

9.2.11 The making of an order recognizing foreign proceedings and other orders in respect of a debtor for whom foreign proceedings have been recognized, does not preclude the debtor company from commencing or continuing proceedings under the BIA, CCAA or the WURA.[98]

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85 BIA, s. 2. CCAA, s. 2.
86 Refer to Part XII of the BIA and Part IV of the CCAA.
87 The UNCITRAL Model Law on Cross-Border Insolvencies is incorporated into the provisions of the BIA and the CCAA but does not appear in Model Law form or language.
88 BIA, s. 268(1); CCAA, s. 45(1).
89 BIA, s. 269(1); CCAA, s. 46(1).
90 BIA, s. 268(1); CCAA, s 45(1).
91 BIA, s. 270; CCAA, s. 47.
92 BIA, s. 268(2); CCAA, s. 45(2).
93 BIA, s. 268(1); CCAA, s. 45(1).
94 *Re Lightsquared LP* 2012 ONSC 2994. See also *Elephant & Castle Group Inc.* (2011), 81 C.B.R. (5th) 102 (Ont. S.C.).
95 BIA, s. 271; CCAA, s. 48.
96 BIA, s. 272; CCAA, s. 49 and 50.
97 BIA, s. 274; CCAA, s. 51.
98 BIA, s. 271(4); CCAA, s. 48(4) and s. 49(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 Question 1 to Question 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 generally excludes fines, penalties, punitive and exemplary damages and any other charges deemed uninsurable. Generally, the coverage will also provide for reimbursement of the costs of a successful defence of penal charges brought in Canada against the directors.

Most policies offer two types of coverage: "Side A", which covers directors and officers personally for non-indemnified claims, and "Side B", which reimburses the corporation for the costs of indemnifying directors and officers. In addition, many policies offer "Side C" coverage, which covers claims made against the corporation itself. A director or officer's claim for indemnity in the case of "Side C" coverage could be drawn from the same policy pool used to pay other claims against the corporation. Claims from these numerous sources can quickly exhaust the available funds, depending on the number and size of the claims and particularly in the case where the corporation is insolvent or approaching insolvency. Similarly, common law rules that provide that insurance coverage is to be paid out as claims are resolved sequentially, with no sharing if limits are exhausted, create another substantial uncertainty as to the adequacy of coverage. These factors are unusually not known before the insolvency process begins.

Director and officer liability policies are typically sold for one-year terms on a "claims-made" basis, which means that coverage will only apply to claims made during the policy period, regardless of when the wrongful act giving rise to the claim occurred. More specifically, a policy is most commonly provided on a "claims-made and reported" basis, where claims must not only be made, but reported to the insurer, during the policy period. Consideration ought to be given to how the terms "director" and "officer" are defined in the insurance policy. For example, the policy may only cover present directors and officers and not past or future directors. In this regard, directors and officers that have resigned may not have coverage.

In order to obtain director and officer liability insurance, the directors and 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, unless the insured or its subsidiaries makes a special request for such service in which case insurance might be provided.

10.3 Indemnification Provisions Under the CCAA

As additional protection under the CCAA, the court has authority to grant a priority charge over all or part of the property of the debtor in favour of any director or officer of the company for an amount necessary to indemnify them against obligations and liabilities they may incur following the commencement of the CCAA proceedings.[99] The charge does not apply in respect of a specific obligation or liability incurred by a director or officer if, in the court's opinion, the liability was incurred as a result of the director's or officer's gross negligence or wilful misconduct or, in Québec, the director's or officer's gross or intentional fault.[100]

The court may not grant the charge if, in its opinion, the company could obtain adequate indemnification insurance for the director or officer at a reasonable cost.[101]

QUESTION 11

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

11.1 Directors' duties

The details of directors' duties are considered above at Question 2. There is a fiduciary relationship between the directors and the company. Two primary fiduciary duties of directors are recognized, namely, a duty of care and a duty of loyalty.

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 2.1.2 and 2.1.3.

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.

Directors 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.

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.[102] 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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[99] CCAA, s. 11.51(1).
[100] CCAA, s. 11.51(4).
[101] CCAA, s. 11.51(3).
[102] *NBD Bank, Canada v. Dofasco Inc.* (2000), 46 O.R. (3d) 514 (C.A.).

APPENDIX A

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, 1997, 2008 and 2009, 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 on 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 (Québec 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. The province of Québec is a civil law jurisdiction that is governed by the Civil Code of Québec (Civil Code).[103] The Civil Code establishes a distinct set of rules that governs secured transactions in that jurisdiction.

Enforcement of security

Section 244 of the BIA provides that a secured creditor that 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, on 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 appointment 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.

[103] (1980), S.Q. 1980, c. 39.

Liquidation

The liquidation of most businesses in Canada is conducted under the BIA. On 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 courts sitting in bankruptcy. On the application of the debtor, the court may, in exceptional cases, stay the rights of a secured creditor for up to six months. For the most part, however, on bankruptcy, secured creditors may proceed to realize upon their collateral with impunity.

The liquidation of financial institutions and certain other institutions is conducted under the WURA, which contains specific provisions regarding the circumstances in which a winding-up order may be made.

In recent years, the CCAA has also been invoked as a means of liquidating a company in circumstances where the courts have found that it is in the best interests of creditors to avoid proceedings under the BIA or WURA and to conduct an orderly liquidation under a plan of compromise or arrangement under the CCAA.

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 that 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 with fewer 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 of group-affiliated liabilities.

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.

Interim financing

As is the case in 11 U.S.C. § 364, the CCAA addresses the subject matter of the debtor obtaining credit during a reorganization. The CCAA provides the court with authority to allow the lien given to an interim financing lender to rank prior to other existing security interests, on notice to existing secured creditors. In deciding whether to make such an order, the court is to consider several factors, including: (i) the period during which the company is expected to be subject to court proceedings; (ii) how the company's business and financial affairs are to be managed during the proceedings; (iii) whether management has the confidence of its major creditors; (iv) whether the loan would enhance the prospects of a viable compromise; (v) the nature and value of the company's property; (vi) whether any creditor would be materially prejudiced as a result; and (vii) the monitor's report, if any.

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 approved by the court, 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.[104] 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.

BIA

Commercial reorganizations under the BIA

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.

[104] Although not impossible, it is highly uncommon for a court to deny sanction of a creditor-approved plan.

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 period 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 five 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 six 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 stay 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. On 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 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. On the appointment of a receiver over all or substantially all of the assets of the debtor, or on 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

The issues concerning the Twilight Zone in China are mainly governed by the Company Law as amended in 2005 (Company Law) and the Enterprise Bankruptcy Law of 2006 (Bankruptcy Law). Both represent the government's serious commitment to market oriented reforms and its efforts to close the gap of the domestic regime with the international rules in corporate and bankruptcy practice. The implementation of these Laws has promoted market discipline and rule of law in China's transitional period towards a market economy.

Presently, China does not have a uniform business enterprise law. The current framework has been developed from a dual-track of legislation: on one line, there are enterprise laws that are adopted based on the ownership classification under the old ideology, such as the 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, the Company Law, the Partnership Enterprise Law (1997 as amended in 2006) and the Sole Proprietorship Enterprise Law (1999), known as the modern enterprise system, have also been introduced into China. As a result, some rules on directors' liabilities may not be strictly consistent under different laws and it may be difficult to discuss them one by one within the limited space of this project. Thus, this chapter will have its primary focus on the provisions of the Company Law, the Bankruptcy Law and related regulations.

In addition to the formal legislation, some other legal rules may also need to be taken into account, such as the judicial interpretations and circulars promulgated by the Supreme People's Court and various state regulatory authorities, such as China Securities Regulatory Commission (CSRC), Ministry of Commerce (MOFCOM) and the State Administration of Industry and Commerce (SAIC). As a country with a strong civil law tradition, judicial decisions are neither systematically reported, nor followed as precedents, although a guiding case practice is being developed by the Supreme People's Court since 2011 to provide the lower courts with practical reference. As a result, this chapter includes a limited number of cases just to illustrate application and enforcement of the laws in practice.

The Chinese Government made a declaration at the end of 2011 that a new legal system with Chinese characteristics had been established. Despite the impressive progress, it should be noted that the business and legal environment in China as a so-called socialist market economy may still be significantly different from other developed jurisdictions. More specifically, on many occasions the government may still have a strong hand and ideological influence on not only the economic policy and the regulation, but also concrete company transactions and bankruptcy cases as a stakeholder. Such conflicting roles of the government may lead to lax enforcement, practical uncertainties, limited independence of the judiciary, and various problems concerning corporate governance, business autonomy, fair dealing and transparent operation.

QUESTION 1

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

Since the "twilight" period concerns both transactions vulnerable to attack and personal liabilities of directors and other parties involved, different laws need to be considered. Chapter 4 of the Bankruptcy Law sets out four types of avoidance powers with different look-back periods. Article 31 of the Bankruptcy Law allows the avoidance power to be exercised to rescind any transaction without consideration or at an obviously unreasonable price, upgrading an unsecured claim to a secured one, making payment for premature debts, or giving up claims that the debtor enterprise may exercise within one year of the bankruptcy petition being accepted by the People's Court.

Second, according to Article 32 a payment of unfair preference made within six months before the People's Court's acceptance of the bankruptcy case may be revoked where the debtor enterprise repays its debts to certain creditors while it is insolvent.[1] It should be noted that unlike other jurisdictions with a single and uniform insolvency test, the Bankruptcy Law sets out two bankruptcy tests: an insolvency test and a balance sheet test. This approach is clearly intended to provide the People's Court with more discretion in making an insolvency declaration.[2] As a result, application of Article 32 may be subject to some uncertainties.

The third type of avoidance targets transfers or concealing of the debtor's assets in order to evade or fabricate obligations. Article 33 of the Bankruptcy Law empowers the bankruptcy administrator to recover all these assets on the ground of *void ab initio* without specifying a timeframe. Finally, any assets of the debtor company seized by its directors, supervisors or senior officers by way of abnormal incomes or misappropriation shall be recovered subject to an unspecified period.[3]

Article 123 of the Bankruptcy Law stipulates that a creditor may petition to the People's Court within two years of the termination of the bankruptcy proceedings, for further distribution, if assets of the debtor are recovered by exercise of the avoidance power or discovered recently. Accordingly, the "twilight" period where transactions are vulnerable to attack may start one year or even earlier (depending on the nature of the transactions subject to attack of the avoidance power) before the commencement of the bankruptcy case and last up to two years after the termination of the proceedings.

In terms of personal liability there are four types of conduct that may subject directors and senior officers to legal liabilities. They may be divided generally into two categories: criminal and civil liabilities. For the former, the Criminal Law of China sets out criminal penalties against wrongdoings of company directors, supervisors and senior officers in dealing with assets of their company, including concealing the company assets or making a false record in the course of liquidation, transfer of the company assets at a price obviously lower than the market price, corruption or misappropriation for personal benefit causing significant losses, particularly to the state-owned companies.[4] The penalties, depending on the gravity of the case, may range from detention, a fine, or potentially even the death penalty.[5] As such, the duration of the twilight period in the criminal law context can be very long because the criminal statutory limitation may run from five years to 20 years depending on the gravity of the case.[6]

The Supreme People's Court promulgated the Provisions on Certain Issues Concerning Trials of Enterprise Bankruptcy Cases on 30 July 2002 (The Supreme People's Court Provisions of 2002). According to this judicial circular, as a measure to combat fraudulent bankruptcy practice, the People's Court shall not accept a bankruptcy petition if the debtor is found to have evaded its obligations by concealing or transferring its assets.[7] Even if a bankruptcy case has been accepted, the People's Court may still turn down the bankruptcy petition, if the conduct of evasion is found or the whereabouts of large funds of the debtor is unknown without reasonable explanation.[8] In these circumstances, the case may be referred directly to the state authority for criminal investigation.[9]

For civil liability cases, in addition to the periods to exercise the avoidance power, Article 125 of the Bankruptcy Law explicitly stipulates that directors, supervisor and senior officers shall be liable for violation of their fiduciary and due diligence duties causing the bankruptcy of the debtor and shall be disqualified on such ground for three years from the end of the bankruptcy proceedings. Article 101 of the Supreme People's Court Provisions of 2002 further provides that the liquidation committee (under the Bankruptcy Law, this should be the power of the bankruptcy administrator) may take legal action against the legal representative or other responsible persons for damages caused by their concealing misappropriation, unfair transfer of the debtor's assets, changing security arrangements, payment of premature debts and giving up the debtors' claims.

The Supreme People's Court promulgated its Provisions on Certain Issues Concerning Application of the Company Law (Part 3) on 27 January 2011. According to Article 14 of the Provisions, directors and other senior officers may be held jointly liable with a shareholder who engaged in their capital flight to the extent of the sum withdrawn, if they assisted such conduct rendering the company unable to repay the debts. As such, the course of action against directors and senior officers in this type of case may reach back to their conduct at the time of aiding and abetting.

According to Article 135 of the General Principles of Civil Law, the statutory limitation to deal with these conducts through civil proceedings is two years, unless the law provides otherwise. The two-year period starts to run when the party concerned knows or should know the infringement, but cannot be longer than 20 years. In practice, the People's Court may also exercise its discretion in applying the laws to a given case. The bankruptcy of Harbin Purchasing Supply Centre in 1995 may serve as 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 period, 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 ab initio* if it is used as a means for unlawful activity.[10]

To sum up, under the current legal regime it seems there is no single "twilight zone¨, but different time frames that subject directors and other persons involved to different liabilities, depending on the nature and gravity of the conduct concerned.

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1 The insolvency test is stated in Article 2 of the Enterprise Bankruptcy Law as the debtor enterprise being unable to repay all the debts due, its assets are insufficient to repay all the debts, or the debtor apparently lacks the capacity of to pay the debts.

2 The insolvency test has been further elaborated upon in the Provisions on Certain Issues Concerning Application of the Enterprise Bankruptcy Law of the Supreme People's Court (Part 1) dated 9 September 2011.

3 *Ibid*, Article 36.

4 See Articles 162, 166, 167, 168, 169 and 271 of the Criminal Law of China of 2011.

5 For example, under Articles 271 of the Criminal Law a director may be sentenced to imprisonment for more than five years for unlawful misappropriation of large sum of company's assets.

6 Article 87 of the Criminal Law of China of 2011.

7 Article 12 of the Supreme People's Court Provisions of 2002.

8 *Ibid*., Article 14.

9 *Ibid*., Article 102.

10 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).

QUESTION 2

2. Actions potentially giving rise to liability for directors

Under the current Company Law, directors and senior officers[11] owe their fiduciary duty to their companies, which includes the duty of loyalty and due diligence and the duty of compliance with the law, regulations and the articles of association of the company.[12] More specifically, a director is prohibited from misappropriating the company's assets, depositing the company's assets in any personal account, providing a loan or security to others in violation of the articles of association, dealing with company in conflict of interests, seizing the company's business opportunity, receiving bribes or secret commissions, disclosing the company's secrets without approval, and other conduct in violation of fiduciary duties.[13]

Article 150 of Company Law stipulates that directors shall be liable for damages to the company caused by their violation of the law, regulations and articles of association in discharging their duties. Moreover, under Article 113 directors shall be responsible for resolutions adopted by the board of directors as a whole. They shall be liable for the loss suffered by the company due to the violation of the law, regulations and the articles of the company by the board resolutions. A director may only be exempted if he has opposed the adoption of the resolution concerned and such opposition was recorded in the minutes of the board meeting. Article 125 of the Bankruptcy Law further provides that directors shall be liable for the bankruptcy caused by their violation of fiduciary and due diligence duties and shall be disqualified for three years at the end of the bankruptcy proceedings.

The mechanism of independent directors has been introduced as a means of improving corporate governance in China. Article 123 of the Company Law requires all listed companies to appoint independent directors and the State Council, as the Central Government, is drafting a regulation in this regard at the time of writing. According to Article 50 of the Principles of Corporate Governance of Listed Companies of 2002 promulgated by the CSRC, independent directors owe their fiduciary and due diligence duties to all shareholders to safeguard the interests of the company, particularly the interests of minority shareholders. As such, a new course of action against independent directors has emerged. In 2001 the CSRC imposed a fine against the directors of Baiwen Company of Zhengzhou City after serious misrepresentations and insolvency was revealed. One of the independent directors lodged his appeal for reconsideration on the ground that his post was just 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 the substantive matter, it has been widely agreed that the case would have [had] significant impact on directors' duty and liabilities.[14]

It should be noted that in China, as a socialist country, directors of different types of enterprises may be subject to different liabilities. Most of the provisions of the Criminal Law mentioned above apply only to directors or managers of state-owned companies and enterprises (SOEs) as measures to protect the state's assets and public ownership.[15] As a result, directors of these companies may face more liabilities during the "twilight period" as compared with directors of other companies.

Together with the enhancement of the legal liability of directors to the company and shareholders, the legal rules on creditor protection have also been improved in recent years. As mentioned above, the Bankruptcy Law streamlines directors' liabilities to creditors in the course of bankruptcy and liquidation proceedings. First, the avoidance power may annul transactions without consideration or below the reasonable price, with unfair preference or even fraudulent intention. Directors are also subjected to the avoidance power for returning the company's assets they misappropriated.[16] Article 128 of the Bankruptcy Law holds the legal representative and other responsible persons liable to compensate creditors for damage caused by their violation in this regard. Article 101 of the Supreme People's Court Provisions (2002) also provides that the legal representative of a bankrupt enterprise and other responsible persons are liable for their unfair or fraudulent transfer of assets.

Secondly, in the course of bankruptcy and liquidation proceedings, the Bankruptcy Law mandates the legal representative of the debtor and other senior officers to cooperate in good faith. In particular, they are under a legal duty to take due custody of the assets, seals, accounts, books and documents of the debtor, faithfully to answer questions to the court, the bankruptcy administrator and creditors, and not to leave their residence without the court's permission.[17] Violation of these duties may lead to the court's summoning for questioning, admonishment and fine.[18] Moreover, without the court's approval, a director and other senior officers cannot transfer any share of the debtor they hold to any third party.[19]

Thirdly, under the Provisions on Certain Issues Concerning Application of the Company Law of the Supreme People's Court (Part 2) of 2008, directors of a company, together with shareholders, shall be liable for losses caused for their failure to commence the voluntary liquidation within the required statutory period.[20] According to Article 184 of the Company Law, the liquidation should begin within 15 days of the taking place of events stipulated either by the law or the shareholders' agreement, such as the end of the operational term or shareholders' agreement. Directors may also be liable to creditors for the disposition of company assets in bad faith[21] or the cancellation of the company's business registration using a false liquidation or without liquidation at all.[22] For insolvent dissolution, Article 183 of Company Law provides that shareholders with 10% voting powers may petition to the People's Court to dissolve the company if the continuation of its operational and managerial difficulties would cause serious losses to the interests of the shareholders and other solutions may not be feasible.

[11] Article 217 of the Company Law defines the scope of senior officers, including managers, chief financial officers, the secretary of listed companies and other individuals stipulated in the articles of association of the company.

[12] Article 148 of the Company Law.

[13] *Ibid.*, Articles 148 and 149.

[14] 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).

[15] Such as Articles 166, 167, 168 and 169 of the Criminal Law of 2011.

[16] Articles 31, 32, 33 and 36 of the Bankruptcy Law.

[17] *Ibid.*, Article 15.

[18] *Ibid.*, Articles 126, 127 and 129.

[19] *Ibid.*, Article 77.

[20] 19 Article 18 of the Second Company Law Provisions of 2008.

[21] *Ibid.*, Article 19.

[22] *Ibid.*, Articles 19 and 20.

As discussed above, directors' liabilities may not be the same in companies of different ownership. For example, in addition to the general rules applicable to all enterprises, the Enterprise State Assets Law of 2008 sets out a separate provision that subjects directors, supervisors and senior officers of enterprises with state investment to loyalty and due diligence obligations and with the duty not to harm the state investment interest,[23] otherwise they shall be disciplined, disqualified or even punished with criminal liability.[24] Moreover, a person responsible for serious losses of state assets will face disqualification from appointment in any state or controlled enterprise for a minimum of five years up to a maximum of life.[25]

The Criminal Law of 1997 includes some articles against directors' unlawful conduct in handling company affairs. Most of these provisions are stipulated as offences for the violation of state regulation of companies and other enterprises, such as unlawful profiteering by taking bribes, or engaging in competing business,[26] causing significant losses to the company by way of dealing with family members and friends,[27] negligence of duties resulting in significant losses to the company,[28] and abuse of powers for their own benefit at the cost of the company.[29] However, virtually all these criminal penalties are only be applicable to cases involving state-owned companies or enterprises or state-owned assets. The criminal liabilities against directors' encroachment of company assets are separately provided for as crimes violating property rights, with more severe penalties against the directors of the SOEs state-owned enterprises.[30] Consequently, the Criminal Law treats SOEs and private companies with different deterrence and punishment schemes.

In recent years new causes of action against directors and senior managers have been introduced. For instance, the Criminal Law amendments have criminalised certain conduct of directors and senior officers of listed companies in violation of their fiduciary duties causing the company to suffer material losses, such as false bankruptcy with asset concealment or other fraudulent transactions,[31]and the provision of funds, services or assets to any entity or individual without capacity of repayment, and. the giving up of claims without sufficient reason.[32] Such criminal liability has been further expanded to failure to make employees' salary payments through transfer or the concealment of assets.[33]

In considering the actions potentially giving rise to liability, the business and legal environment in China should be taken into account. On the one hand, the culture of market trust and credit is still weak compared to other developed market economies. Certain legal protection to creditors, such as insolvent trading, has not been stipulated in the Company Law or the Bankruptcy Law. Actions against directors' wrongdoings are still difficult due to the developing infrastructure and lack of institutional support. On the other hand, the imposition of liability against directors thus far seems primarily to focus on the losses or damage to the company or creditors without paying sufficient attention to the mental state of the director concerned and the market conditions. Business judgment protection, for instance, is not available as a defence in the current legal regime.

QUESTION 3

3. Other persons may be liable during the "twilight" period

Given the current corporate structure and business environment, other persons, in addition to directors, may also be liable as a result of their involvement in the affairs of the companies in the "twilight zone". First, the Company Law is based on the German model with a supervisory board, as an organ to monitor directors' performance for shareholders. In terms of duties and liabilities owed to the company, a supervisor is treated virtually the same as a director. As such, if supervisors fail to carry out their fiduciary and other duties, the same liabilities will be imposed on them. The Company Law has significantly expanded the supervisors' powers in corporate governance, including the examination of a company's financial condition, a motion to dismiss directors and senior officers, convening of general meetings, carrying out their own investigation into the company's affairs by appointing professional firms, and filing legal actions against directors and senior officers to the People's Court.[34] As a result, supervisors may be liable for any violation of the law, regulations, articles of association, and their fiduciary duties which causes losses or bankruptcy of the company[35] and damage to creditors.[36]

The Company Law also for the first time defines senior officers, the controlling shareholder and the de facto controller of a company and subjects them to various legal liabilities. According to Article 217(1), senior officers include managers, deputy managers, persons in charge of the financial affairs of the company, the secretaries of listed companies and other individuals specified in the articles of association. In general, a senior officer shall owe the same duties and attract the same liability as a director.[37]

A controlling shareholder is defined as a shareholder who contributes or owns more than 50% of the company shares, or whose holdings are sufficient to have a significant influence on resolutions of the general meeting although the holdings may not be up to 50%.[38] A non-shareholder may be deemed a de facto controller as a result of his actual control over the company through agreements or other arrangements.[39] Articles 20 and 21 of the Company Law hold shareholders, particularly the controlling shareholders and the de facto controller, liable under the doctrine of "lifting the corporate veil" for their serious infringement of creditors' interests by abusing the corporate entity and causing damage to the company through transactions with their affiliates.

23 Article 26 of the Enterprise State Assets Law of 2008.
24 *Ibid*., Article 71.
25 *Ibid*., Article 41.
26 Articles 165 — 169 of the Criminal Law of 2011.
27 *Ibid*., Article 166.
28 *Ibid*., Article 167.
29 *Ibid*., Articles 168 and 169.
30 *Ibid*., Articles 271 and 272.
31 Article 6 of the Sixth Criminal Law Amendment dated 29 June 2006.
32 *Ibid*., Article 9.
33 Article 41 of the Eighth Criminal Law Amendment dated 25 February 2011.
34 Articles 54, 55, 119 and 152 of the Company Law.
35 *Ibid*., Article 150.
36 Article 125 of the Bankruptcy Law.
37 Articles 148, 149, 150 and 153 of the Company Law and Article 125 of the Bankruptcy Law.
38 Article 217 (2) of Company Law.
39 *Ibid*., Article 217.

In some cases bankrupt companies were established by government organisations without sufficient capital to meet the minimum capital requirement. In practice, even before the amendment to the Company Law, the People's Court has repeatedly held the government liable in this circumstance. 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 that the government office should be held 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.[40]

In addition, the promoters and shareholders of a company will be liable for any failure to make their capital contribution or withdrawal of their capital contribution after the formation of the company. Articles 31 and 94 of the Company Law respectively require a shareholder of a limited liability company or joint stock company who fails to make his capital contribution according to the articles of association to make up the balance, whilst other original shareholders or promoters shall be jointly liable for it. Article 200 further imposes a fine of 5-15% of the unpaid or falsely paid sum against such a shareholder or promoter. Moreover, the de facto controller may also be jointly liable to the company's creditors for aiding and abetting the unlawful withdrawal of registered capital by any shareholder.[41]

The Company Law introduced for the first time the one man company into China. However, the new form of company was adopted against concern for potential abuse. As a result, the sole member of a one man company, has not only to pay a much higher statutory capital of RMB 100,000 before establishment, (instead of RMB 30,000 as the stipulated minimum statutory capital for non-one man limited liability companies), but also has to prove the separation of his personal property from the company's assets, or else he shall be liable jointly with the company.[42]

As a socialist market economy, the top management of SOEs and state-controlled companies are still appointed by the government. As discussed above, the liability for abusing powers, neglecting duties and crimes leading to losses of the state assets are not limited to directors of the companies/enterprises concerned, but apply generally to all the responsible individuals. Moreover, the government supervising authorities may also be liable for their unlawful interference with the business operation of SOEs or government-controlled companies causing serious losses of state assets.[43]

The Bankruptcy Law replaced the government-controlled liquidation group with a new system of a bankruptcy administrator. Under Articles 13 and 122 of the Bankruptcy Law, a bankruptcy administrator is appointed by the People's Court when a bankruptcy petition is accepted and his duty ends when the debtor's business registration is cancelled after the termination of the bankruptcy proceedings, unless there are unfinished legal actions or arbitral proceedings. During this period, the bankruptcy administrator reports to the People's Court and is subject to the supervision of the creditors' meeting.[44] He shall carry out his due diligence and faithfully discharge his duties.[45] In case of violation of his legal duties, a bankruptcy administrator may be fined and held liable to compensate losses caused to creditors or a third party.[46]

In the course of marketisation, professionals have been playing an increasingly important role and their practising ethics and standards are also rapidly developing. For example, the Company Law includes a provision against firms that commit false asset appraisal, verification and certification, and material omission. They will be subject to a fine of up to five times their income from the relevant case, revocation of the firm's license, disqualification of the professionals involved, and civil liability to compensate the victims concerned, unless they can prove their innocence.[47] The Supreme People's Court has held the Housing Administration of Nanchang City liable for RMB 2.48 million of damages to the bank that granted a loan of RMB 7 million to the debtor on reliance of the Housing Administration's appraisal of a flat as collateral of the borrower. The Housing Administration was found negligent in verifying the property documents in violation of the professional standards, which rendered the fraudulent borrowing possible.[48]

The Commercial Bank Law of 2003 prohibits a commercial bank from granting loans on a credit basis to its affiliate or granting other types of loans with preferential conditions.[49] Further, Chapter 5 of the Law on Administration of Banking Regulation of 2003 in particular specifies administrative and criminal liabilities against violations of the banking law and loaning procedures.

The current law does not have clear rules on the liability of a third party in the "twilight zone". However, the very general and broad provision of the General Principles of Civil Law of 1986 may always be relied on by the court to deal with a third party who enters into transactions 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 liability for his violation of another's property rights. Articles 17 and 38 of the Bankruptcy Law subjects a third party possessor of the debtor's assets to a legal obligation to return them to the bankruptcy administrator. Moreover, upon completion of the bankruptcy proceedings, the guarantor and any third party who is jointly liable for the unpaid debts shall be responsible for the settlement of the unpaid debts of the bankrupt enterprise.[50]

Finally it should be noted that in China criminal liability is widely imposed. For all the parties and conduct identified above, criminal penalties may be applied once the violation is considered to have reached a grave level.[51]

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40 The case is reported in the Research Office of the Supreme People's Court, Collection of Judicial Interpretations of the Supreme People's Court, vol. 1 (1949-1993), (People's Court Publishing House, 1994), at 1570-72 (in Chinese).

41 Article 14 of the Provisions on Certain Issues Concerning Application of the Company Law of the Supreme People's Court of 2011 (Part 3).

42 Articles 59 and 64 of the Company Law. The minimum statutory capital stipulated in the Company Law for other limited liabilities is RMB 30,000. See Article 26 of the Company Law.

43 *Ibid*., Article 38.

44 Article 23 of the Bankruptcy Law. The duties of a bankruptcy administrator are stipulated in Article 25 of the Bankruptcy Law.

45 *Ibid*., Article 27.

46 *Ibid*., Article 10.

47 Article 208 of the Company Law.

48 *Jiangxi Branch of the Bank of China v. Housing Administration of Nanchang City*, (The Supreme People's Court, decided on 30 September 2003; Printed at the Bulletin of the Supreme Court of PRC, issue 2 (2004), at 22-27 (in Chinese).

49 Article 40 of the Commercial Bank Law of 2003.

50 Article 124 of the Bankruptcy Law.

51 Article 131 of the Bankruptcy Law and Article 216 of the Company Law.

QUESTION 4

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

Generally, as discussed above, transactions with the debtor company less than six months prior to the commencement of the bankruptcy proceeding may be vulnerable to the attack pursuant to the avoidance power if the debtor was insolvent at the time of such payments.[52] Certain actions within one year of the commencement of the bankruptcy proceeding may be avoided against counterparties who have received assets from the debtor company without consideration or at an apparently unreasonable price, or who have become better off due to their security status being upgraded to the detriment of other creditors, who have received premature payment, or whose obligation to the debtor has been waived.[53] By the same token, all unlawful income made by insiders of the debtor company, including directors, supervisors, and senior officers in abuse of their power recoverable by the bankruptcy administrator.[54]

The Supreme People's Court adopted its Interpretation on Certain Issues Concerning Application of Contract Law (Part 2) on 24 April 2009. The Interpretation sets out, inter alia, some guidelines for the practical application of Article 74 of the Contract, which allows a creditor to set aside a transaction of the debtor through judicial proceedings if the transaction damages his lawful interest due to the debtor giving up its claims, transferring assets without consideration or at an unreasonably low price. According to Article 19 of this Interpretation, a price which is 30% below the market price (or alternatively the price adopted by the government to guide the market) shall be considered unreasonable, although other factors may also be taken into account.

As a general rule, during a liquidation, the company shall not continue to carry out business activities irrelevant to the liquidation.[55] As a result, to what extent a pre-bankruptcy contract can be recognised, performed and enforced is to be decided by the bankruptcy administrator.[56] Under the Bankruptcy Law, any payment to a creditor by the debtor after the commencement of bankruptcy proceedings is null and void.[57] Moreover, according to the "automatic stay rule", all the civil lawsuits and arbitral proceedings that have been started, but not completed, shall not be carried on until the bankruptcy administrator takes over the debtor's assets.[58] Moreover, all enforcement proceedings are also be suspended until after the bankruptcy petition is accepted by the People's Court.[59]

Under Articles 25 (5), 26 and 61 (5) of the Bankruptcy Law, the bankruptcy administrator, the People's Court and the creditors' meeting may decide whether the debtor can continue its business operation after the commencement of bankruptcy proceedings. More importantly, as a result of the bankruptcy law reform in 2006 a reorganisation system has been introduced into China based on the "debtor remaining in possession" during the reorganisation period.[60] In order to facilitate a smooth reorganisation, secured creditors may not exercise their priority claims and further security may be created to support the continuing operation of the debtor company in the reorganisation period.[61] Creditors of the debtor may also reach settlement in respect of the unpaid debts.[62] Thus, counterparties may still be able to deal with the company in the "twilight zone". However, the rules of the current regime are still not detailed enough to guarantee clarity and certainty.

QUESTION 5

5. Enforcement actions

According to Articles 31, 32, 34, 35 and 36 of the Bankruptcy Law, the bankruptcy administrator is empowered to petition the People's Court to avoid unfair or fraudulent transactions against third parties, shareholders of the debtor company with unpaid contributions, the directors, supervisors and senior officers of the debtor and creditors concerned to recover the assets of the debtor. The public security department and the People's Procuratorate may step in to carry out criminal investigations and prosecutions, if needed, in a case of serious violation that may trigger criminal liability.[63]

The debtor company may have a cause of action against its directors, supervisors and senior officers for breach of their legal duties and for violation of the law, regulations and the articles of the company resulting in loss to the company. They will be liable to compensate the company for losses caused by their wrong-doing and will further be accountable to the company for any unlawful income they have made by means of corruption, misappropriation, and conflict of interest dealings.[64] If the company or the supervisors fail to take the legal action requested, shareholders may institute a derivative action on behalf of the company,[65] or claim in their own names.[66] Moreover, the creditors and debtor company may also sue the controlling shareholder and the de facto controller on the grounds of abusing the corporate entity[67] and abusing their status through transactions with their affiliates.[68]

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[52] Article 32 of the Bankruptcy Law.
[53] *Ibid*., Article 31.
[54] *Ibid*., Article 36.
[55] Article 206 of the Company Law.
[56] Articles 18 and 20 of the Bankruptcy Law.
[57] *Ibid*., Article 16.
[58] *Ibid*., Article 20.
[59] *Ibid*., Article 19.
[60] *Ibid*., Article 73.
[61] *Ibid*., Article 75.
[62] *Ibid*., Chapter 9.
[63] *Ibid*., Article 131 and Article 216 of the Company Law.
[64] *Ibid*., Articles 113 and 150.
[65] *Ibid*., Article 152.
[66] *Ibid*., Article 153.
[67] *Ibid*., Article 20.
[68] *Ibid*., Article 21.

Although the doctrine of insolvent trading has not been introduced through formal legislation, the Supreme People's Court has adopted some rules which may lead to a similar practical effect. According to Article 1 of the Second Company Law Provisions of 2008, serious operational difficulties may be a sufficient ground to dissolve a company through liquidation. In such a case, creditors may take legal action against shareholders, directors, the controlling shareholder or the de facto controller of the debtor company for their failure to commence the liquidation within the statutory period causing losses to the company and the disposition of the company's assets in bad faith or without liquidation.[69]

The creditors' meeting or the creditors' committee has the power to supervise the bankruptcy administrator in the performance of his duties. They may take the matter to the People's Court if the bankruptcy administrator refuses the supervision.[70] The debtor or a third party may sue the bankruptcy administrator for damages caused by his failure to duly perform his duties.[71] The People's Court may also take its own initiative to penalise directors and other relevant persons for their refusal to cooperate, dishonest conduct and other violations.[72]

The Second Company Law Provisions of 2008 further entitle creditors to take legal action against shareholders of an insolvent company for their unpaid capital subscription,[73] and against members of the liquidation group for damages caused by their violation of the law, regulations or the articles of the company.[74]

As stated above, the upper-level state department of the SOEs concerned and the State Commission of State Assets Administration and Supervision are empowered to discipline persons responsible for serious losses of state assets due to their wrongdoing or neglect of their duties. These kinds of case may even lead to criminal prosecution.[75]

QUESTION 6

6. Remedies: orders available to the domestic court

In addition to the criminal and administrative penalties including disqualification discussed above, this section will discuss the legal remedies for civil liability, which can be roughly divided into three categories:

(a) civil compensation, which is widely used at all stages in the "twilight zone" and can be applied to the debtor company, directors, supervisors and senior officers, the controlling shareholders, and the de facto controller of the company, the professionals involved and their firms, the bankruptcy administrator, third parties dealing with the company in bad faith for their violation of the law, regulations and the articles of association, breach of fiduciary duties or other wrongdoings;

(b) restoration, which may include the return of the company's assets by company insiders due to their misappropriation, by third parties for their possession, reception through unfair preference or fraudulent or unfair trading, or by shareholders for their unpaid capital contributions; and

(c) procedural measures and enforcement, which may include "automatic stay", adjudication of the disputes between/among the parties concerned in the bankruptcy and liquidation proceedings,[76] and measures to compel the return of assets, account books and documents,[77] and the presence of management of the debtor.[78]

(d) dismissal of the bankruptcy administrator if he cannot perform his duty fairly and competently in accordance with the law.[79] The Supreme People's Court in its Provisions on Appointment of Administrators in Enterprise Bankruptcy Cases of 2007 further articulated the legal grounds for dismissing a bankruptcy administrator which may include loss of his practising licence or civil capacity, conflict of interests, gross negligence or bad intention, incompetence, violation of the law and expiration of his insurance.[80]

QUESTION 7

7. Duty to co-operate

The Bankruptcy Law and the Supreme People's Court's Provisions on Certain Issues Concerning Trials of Enterprise Bankruptcy Cases of 2002 set out the rules relating to the duties of directors and senior officers of the debtor company to cooperate with the bankruptcy administrator and the court during the "twilight zone" period.

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[69] Articles 18, 19 and 20 of the Second Company Law Provisions of 2008.
[70] Article 68 of the Bankruptcy Law.
[71] *Ibid*., Article 130.
[72] *Ibid*., Articles 126, 127 and 129.
[73] Article 22 of the Second Company Law Provisions of 2008.
[74] *Ibid*., Article 23.
[75] Chapter 8 of the State Assets Law.
[76] Such as dispute on the debts owed and its registration between the debtor and the creditor (Article 58 of the Bankruptcy Law), dispute on the distribution plan (*Ibid*., Articles 65 and 66), dispute between creditors and the bankruptcy administrator on supervision (*Ibid*., Article 68), and dispute on reorganisation plan (*ibid*., Article 87).
[77] *Ibid*., Article 127.
[78] *Ibid*., Articles 126 and 129.
[79] Article 22 of the Bankruptcy Law
[80] Articles 26, 33 and 34 of the Provisions on Appointment of Administrators in Bankruptcy Cases.

First, when submitting the bankruptcy application, the debtor is required to explain the cause of its losses and submit relevant accounting books, a detailed list of liabilities, accounts receivable, the employees' settlement plan, the record of payment of employees' wages and their social security and other relevant documents to the People's Court.[81] If the bankruptcy petition is filed by a creditor, after accepting the case, the People's Court shall ask the debtor to submit all the relevant account books and documents specified above within 15 days.[82] A fine will be imposed against the responsible individuals for their refusal to hand over the books and documents or for falsifying or destroying the documents.[83]

Second, once the bankruptcy administrator has been appointed, the debtor is required to hand over operation of its business and affairs to the administrator[84] and not to make any payment to individual creditors.[85] Moreover, Article 15 of the Bankruptcy Law mandates the legal representative, financial officer and other relevant management of the debtor to take due custody of the assets, seals, account books and other documents under their possession, to carry out their necessary work and faithfully answer the questions according to the request of the People's Court and the bankruptcy administrator, to attend the creditors' meetings and faithfully answer the creditors' inquiries, not to leave their residence without the court's permission, and not to appoint any new director, supervisor or senior officer. Any violation of these legal duties may lead to a mandatory summons, reprimand, fine or detention by the People's Court.[86]

Third, under the Bankruptcy Law both the creditors and the debtor may apply to the People's Court for reorganisation. If the reorganisation plan is approved by the People's Court, the debtor will take possession of the assets to carry on its business under the supervision of the bankruptcy administrator.[87] In the period of reorganisation, the debtor and its management shall implement the reorganisation plan in good faith and in a co-operative way with the bankruptcy administrator; otherwise the People's Court may upon the request of an interested party terminate the reorganisation and make the bankruptcy declaration.[88] The debtor enterprise may also reach settlement with its creditors. Such settlement must be made bona fide; a settlement shall be avoided by the People's Court if it is made by fraudulent or other unlawful means.[89]

In dealing with a bankruptcy case, other People's Courts will have a duty to co-operate with the Court hearing the bankruptcy case. According to Article 36 of the Supreme People's Court Provisions of 2002, after the bankruptcy declaration, in a case where the bankrupt enterprise's properties have been sealed up, detained or frozen in other civil proceedings, the People's Court that hears the bankruptcy case shall immediately notify the People's Courts that have taken the measure of sealing up, detraining or freezing the properties to cancel the measures and transfer them to the bankruptcy court.

With regard to the imposition of criminal liabilities in the "twilight zone" period, the legal regime has been improved recently through the amendments to the Criminal Procedure Law in 2012. For example, under Article 50 of the Law the state authority shall not force self-incrimination of the defendant. Another concern in this regard is that the defendant's right of access to lawyers may be restricted during some periods. According to the Law, a criminal defendant may have the right to appoint his attorney only after the state authority completes its first interrogation or compulsory measures.[90] Moreover, a lawyer may not have access to the file of the case or verify the evidence with his client until after the public security office has completed its investigation and transferred the file to the People's Procuratorate for prosecution.[91]

As a whole, China has made notable progress in terms of protection of the lawful rights of defendants which are codified in the Criminal Procedure Law and relevant laws and regulations. In addition to the provisions in the Constitution Law,[92] the Criminal Procedure Law contains provisions to safeguard the fundamental rights of the suspects. A director may rely on these articles to protect his lawful rights.[93] However, at local level full compliance with the legal rules may still be a challenge to the judiciary and the government. For instance some cases have been reported in recent years where even foreign businessmen were unlawfully detained with maltreatment in debt disputes.[94]

QUESTION 8

8. Appeals and limitation periods

In the bankruptcy and reorganisation period, some appeal procedures are stipulated. For example, parties may appeal to the People's Court at the next upper level against the ruling of the lower court not to accept the bankruptcy petition within 10 days of the decision.[95] Creditors who refuse to accept the court ruling on disposition of the debtor's assets and the distribution plan may request the same People's Court to reconsider its ruling within 15 days of the pronouncement of the decision. However, reconsideration does not stop implementation of the decision, although it might be changed later.[96]

[81] *Ibid.*, Article 8; and Article 6 of the Supreme People's Court Provisions of 2002.
[82] *Ibid.*, Article 11.
[83] *Ibid.*, Article 127 and Article 8 of the Supreme People's Court Provision on Certain Issues Concerning Application of Bankruptcy Law (Part 1).
[84] *Ibid.*, Article 25.
[85] *Ibid.*, Article 16.
[86] *Ibid.*, Articles 126 and 129.
[87] *Ibid.*, Articles 73,89 and 90.
[88] *Ibid.*, Articles 78 and 93.
[89] *Ibid.*, Article 103.
[90] Article 33 of the Criminal Procedure Law of 2012.
[91] *Ibid.*, Articles 37 and 38.
[92] Article 33 of the Constitution of China states that the State respects and protects human rights. The Constitution of the People's Republic of China was adopted at the fifth session of the fifth National People's Congress on 4 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.
[93] For example, a defendant shall have the right to defence, and the People's Courts shall have the duty to guarantee his defence under Article 11. See also Articles 12, 14, 32, 47, 50, and 54 of the Criminal Procedure Law of 2012.
[94] For a recent report, see "Kidnapped Indian Businessman in China Released", Daily News and Analysis (India), 25 May 2012, available at http://www.dnaindia.com/print710.php?cid=1693696.
[95] Article 12 of the Bankruptcy Law.
[96] *Ibid.*, Article 66.

Generally, according to Articles 135 and 137 of the General Principles of Civil Law, the statutory limitation of civil actions is two years from the time of infringement or the time the injured party knows or should have known of the infringement. This period may be a variable period due to suspension[97] or interruption.[98] However, under Article 137 of the General Principles of Civil Law, the People's Court will not entertain any civil action if 20 years have lapsed since the infringement. As such the 20-year period is an invariable period, regardless of any suspension or interruption.

Under the Bankruptcy Law, creditors must accept distribution of the bankruptcy proceedings within two years. If a creditor fails to do so, the People's Court will distribute the assets concerned among the other creditors.[99] Moreover, creditors may petition the People's Court if new or further assets are discovered within two years of termination of the bankruptcy proceedings.[100]

Currently, there is no special limitation period applicable to actions against directors and other officers. As a result, the general limitation of civil and criminal actions is applied to these actions. Moreover, a director who is penalised with administrative sanctions, such as administrative fine or disqualification under the Bankruptcy Law and Company Law, may either ask the relevant state authority to reconsider the penalty imposed against him within 60 days of his knowledge of the penalty,[101] or directly petition the People's Court to strike down the administrative decision within 3 months.[102]

Where directors and other officers' conduct constitutes a criminal offence, the limitation period prescribed in the Criminal Law of PRC shall apply. In accordance with Article 87 of the Criminal Law of China of 2011, crimes are not to be prosecuted where:

(a) in cases where the maximum legally prescribed punishment is fixed-term imprisonment of less than five years, five years have elapsed;

(b) in cases where the maximum legally prescribed punishment is fixed-term imprisonment of more than five years but less than 10 years, 10 years have elapsed;

(c) in cases where the maximum legally prescribed punishment is fixed-term imprisonment of more than 10 years but less than 15 years, 15 years have elapsed; and

(d) in cases where the maximum legally prescribed punishment is either life-imprisonment or the death penalty, 20 years have elapsed.

With the approval of the Supreme People's Procuratorate, prosecution may be filed beyond the 20 year limitation in special cases.[103]

Thus, the legally-prescribed punishment periods should be decided first according to the relevant articles in order to determine the limitation period applying to a criminal action against directors. With respect to actions against them, there is no specific provision governing their appeal. Thus, appeal against the decision of the first instance court proceedings is governed by the relevant rules of civil, criminal and administrative procedure laws respectively.

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 has the right to lodge an appeal with the People's Court at the next level within 15 days of the date on which the written judgment was 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 has the right to file an appeal with the People's Court at the next level within 10 days of service of the written order.

If a defendant in a criminal proceeding refuses to accept a judgment or order of the first instance court, he has the right to appeal in writing or orally to the People's Court at the next higher level according to Article 216 of the Criminal Procedure Law of 2012. The time limit as set out in Article 219 of the Law for an appeal or a protest against a judgment is 10 days. The time limit for an appeal or a protest against a procedural order is five days. The time limit is counted from the day when 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 relevant 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 the Administrative Procedure Law of 1989. According to Article 38 of the Administrative Procedure Law, if a citizen, a legal person or any other organisation applies to an administrative organ for reconsideration, the organ must make a decision within two months from the day of receipt of the application, except as otherwise provided for by the law or regulations.

Anyone who refuses to accept the reconsidered decision may bring a lawsuit before the People's Court within 15 days of receipt of the reconsidered decision. If the administrative organ conducting the reconsidered fails to make a decision on the expiration of the time limit, the applicant may bring a lawsuit before the People's Court within 15 days of the time limit for reconsideration expiring, except as otherwise provided for by the law. The party may further appeal his case to the next level of the People's Court within 15 days after being served with the judgment of the first instance court.[104]

[97] According to Article 139 of the General Principles of Civil Law of 1986, 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.

[98] Article 140 of the General Principles of Civil Law provides that a limitation of action shall be discontinued if a lawsuit is brought or if one party makes a claim for or agrees to fulfilment of his obligations. A new limitation shall be counted from the time of the discontinuance.

[99] Article 119 of the Bankruptcy Law.

[100] *Ibid.*, Article 123.

[101] Article 9 of the Administrative Reconsideration Law of 1999.

[102] Article 39 of the Administrative Procedure Law of 1990.

[103] 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. Article 89 of the Criminal Law of 2011.

[104] Article 58 of the Administrative Procedure Law of 1989.

QUESTION 9

9. Foreign corporations

Foreign company is defined in Article 192 of the Company Law as “a corporation that is established according to foreign laws in a foreign jurisdiction”. Foreign companies may carry out their business operation in China by way of a branch office, subsidiary, wholly foreign owned enterprise, limited liability company, joint stock companies or joint venture. Since the Bankruptcy Law applies to all types of enterprises with legal person status, the bankruptcy or liquidation, as applicable, of foreign branches, subsidiaries, investment companies and enterprises in China should be governed by the Bankruptcy Law.

Article 196 of the Company Law provides that a branch of a foreign company shall not have legal person status in China and the foreign company must be responsible for all the liabilities the branch has incurred in China. Article 198 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 must not be moved outside China before the completion of the liquidation.

As far as foreign investment companies and enterprises in China are concerned, the law treats them as a Chinese legal person since they are registered in China under Chinese law. Although to a large extent the dual track system is retained for the time being with separate rules applicable to foreign investment enterprises, the gap has been narrowed in recent years. For example, the MOFCOM promulgated the Guiding Opinion on Dissolution and Liquidation of Foreign Investment Enterprises on 5 May 2008. It abolished the Liquidation Measures of Foreign Investment Enterprises of 1996, which was only applicable to foreign joint ventures and wholly foreign owned enterprises for their voluntary liquidation in China. As a result, voluntary liquidation of solvent foreign investment enterprises is governed by the Company Law, unless foreign investment laws provide otherwise; whereas their insolvent liquidation now is under the jurisdiction of the Bankruptcy Law.

Although there is no specific provision on whether transactions in the “twilight zone” are applicable to foreign corporations, the rules of directors’ duties and responsibilities are equally applicable to foreign companies in China. For instance, Article 197 of the Company Law stipulates that a branch of a foreign company shall abide by the laws and regulations of China and shall not harm the social public interests of the nation. Thus, directors of foreign companies may be held liable if they commit unfair preference or fraudulent trading causing damages to the creditors, their companies or the social public interests of China.

It should be noted that the Bankruptcy Law has introduced a provision to address cross-border insolvency for the first time. Article 5 provides that the legal effects of bankruptcy proceedings under the Bankruptcy Law shall reach assets outside the territory of China. In order to enforce an effective decision of a foreign court made in foreign bankruptcy proceedings concerning assets in the territory of China, an application must be filed with the People’s Court. The People’s Court will examine the foreign judicial decision in accordance with the laws of China, the international treaties that China has acceded to, and the reciprocity principle. The foreign ruling will be recognised and enforced if it does not violate the fundamental principles of Chinese law, the national sovereignty, safety and social public interests of China as well as the lawful interests of creditors within the territory of China.

QUESTION 10

10. Insurance

Given the short experience of a market economy, liability insurance for directors and officers (D&O insurance) is still underdeveloped in China. Such insurance was not recognised by the government regulation until 2001 when the CSRC in its Guiding Opinions to Establish the Independent Director System in Listed Companies allowed necessary insurance arrangements to lower the risks of independent directors in performing their duties.[105] The CSRC further adopted the Principles of Corporate Governance of Listed Companies in 2002 which stipulates that, with the approval of the shareholders’ meeting a listed company may purchase liability insurance for its directors; however, the liabilities of directors for their violation of the law, regulations and the articles of association of the company are excluded.[106] On this basis, some insurance companies have marketed their D&O insurance programs.

However, presently less than 2% of 13,300 directors of more than 2000 listed companies in China have purchased liability insurance. Such condition should be first blamed on some institutional defects. First, the inadequacy of relevant insurance legislation gives rise to difficulties in the development of D&O liability insurance. The current D&O insurance regime is, to a large extent, merely confined to the listed companies with low rank administrative circular. The Company Law does not include any permissive or enabling provision in this regard. Secondly, although in recent years the increasing number of liability cases against directors and senior officers has attracted more attention to the D&O insurance, the developing legal regime and corporate governance have on many occasions become obstacles for creditors and shareholders to seek effective legal remedies. Thus far, only a very limited number of directors and senior officers have been held personally liable in legal proceedings. Finally, the market risks and uncertainties in China’s transitional period towards a market economy are much greater compared to other developed jurisdictions. As a result, insurance companies may have to take a self-protective approach by including many exclusive and exceptional clauses in their insurance policies, which will inevitably in turn negatively affect the value of the D&O insurance products in the market.[107]

[105] Article 7 (6) of the Guiding Opinions to Establish the Independent Director System in Listed Companies promulgated by the Chinese Securities Regulation Commission on 16 August 2001.

[106] Article 39 of the Principles of Corporate Governance of Listed Companies promulgated by the CSRC on 7 January 2002.

[107] The information is collected from the report on directors’ liability insurance of Zhengquan Shibao (Securities Times), 7 January 2012, at http://stock.stcn.com/content/2012-01/07/content_4412070.htm (in Chinese).

QUESTION 11

11. Incurring further credit and counter-party risks in dealing with a company during the "twilight period"

The Bankruptcy Law does not prohibit the debtor from incurring further debts after entering into the "twilight zone" so long as they are fair and bona fide and meet the procedural requirements. For instance, after commencement of bankruptcy proceedings the bankruptcy administrator has the power to decide how to deal with contracts that have not been performed and to notify the counter-parties accordingly. If the administrator does not notify the counter-party concerned within two months of commencement of the bankruptcy proceedings or does not reply to the counter-party's request urging the performance within 30 days, the contract shall be deemed discharged. On the other hand, the counter-party is entitled to demand security if the bankruptcy administrator decides to continue to perform the contract.[108]

Although the Bankruptcy Law prohibits unfair preference of an insolvent debtor by payments to any creditor within six months before the commencement of the bankruptcy proceedings, the exception under Article 32 of the Law may be applied if such payments are proved beneficial to the debtor and its property.

Article 41 of the Bankruptcy Law defines the scope of the bankruptcy costs, which include the legal costs of the bankruptcy proceedings, the costs of administration, liquidation and distribution of the debtor's assets and the remunerations of the bankruptcy administrator and other staff involved. Moreover, the certain debts incurred after commencement of the bankruptcy proceedings shall be the common debts of all the creditors, such as debts incurred for performing the relevant contracts, managing the relevant assets, tort liabilities caused by the debtor and the bankruptcy administrator, and settlement of labour costs and social insurance for debtor's continuing operation in the course of the bankruptcy proceedings.[109]

In order to ensure the smooth implementation of a reorganisation plan the priority claims of the secured creditors shall be suspended during the reorganisation period. However, the secured creditors concerned may demand the exercise of their rights if their interest may be affected due to the damages to the secured properties or significant loss of their value in the reorganisation. The debtor or the bankruptcy administrator may create further security for new borrowings for the continuing operation of the debtor company for reorganisation.[110]

Article 40 of the Bankruptcy Law sets out some general rules governing set-off in the course of bankruptcy. A set-off shall not be permitted if the obligor of the debtor company did not obtain its obligatory claim against the debtor until after the bankruptcy petition has been accepted by the People's Court; the obligor of the debtor company obtained its claim against the debtor with the knowledge of the debtor's insolvency or bankruptcy, except the claim was obtained due to the performance of statutory duties or considerations less than one year before commencement of the bankruptcy petition. If the claim cannot be set-off, the counter-party may only participate in the bankruptcy proceeding as a general creditor for repayment by way of bankruptcy distribution.

[108] Article 18 of the Bankruptcy Law.
[109] *Ibid.*, Article 42 and 43.
[110] *Ibid.*, Article 75.

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. A company will be deemed insolvent if it is unable to pay its debts, which may be established by proving:

(a) the company becomes unable to pay its debts as they fall due - the "cash-flow" test; and/ or

(b) the company's liabilities exceed the value of its assets - the "balance sheet" test[2].

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 or should have realised that it was unreasonable to think that the company would avoid insolvent liquidation (that is, 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 considerations, it is worth mentioning that a director's statutory duty to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as whole is displaced when a company is insolvent. In these circumstances, the law recognises the economic reality of the company's position[3] and the directors must exercise their powers and discharge their duties having regard to the interests of creditors of the company.

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;

(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] 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] The distinction between the balance sheet test and the cash-flow test has been rather blurred by the Court of Appeal's decision in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007 3BL plc & Others* [2011] EWCA Civ 227. The Court stated that the balance sheet test is not a pure 'mechanical' test whereby if liabilities exceed assets as shown on the company's balance sheet, it will be deemed insolvent. Rather, the question is whether the shortfall in assets relative to liabilities is indicative of an actual inability to pay future and contingent debts as they fall due or if the company has reached "the point of no return".

[3] That the shareholders' funds are exhausted and it is the creditors' money that the directors are 'playing with'.

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 (e.g. security, charges) - six months, or two years if the preferred person is connected (sections 239 and 240(1) (a) and (b)[4]);

(b) voidable floating charges - 12 months, or two years if the holder of the floating charge is connected (section 245(3));

(c) transactions at an undervalue (e.g. guarantees) - two years (sections 238 and 240(1)(a));

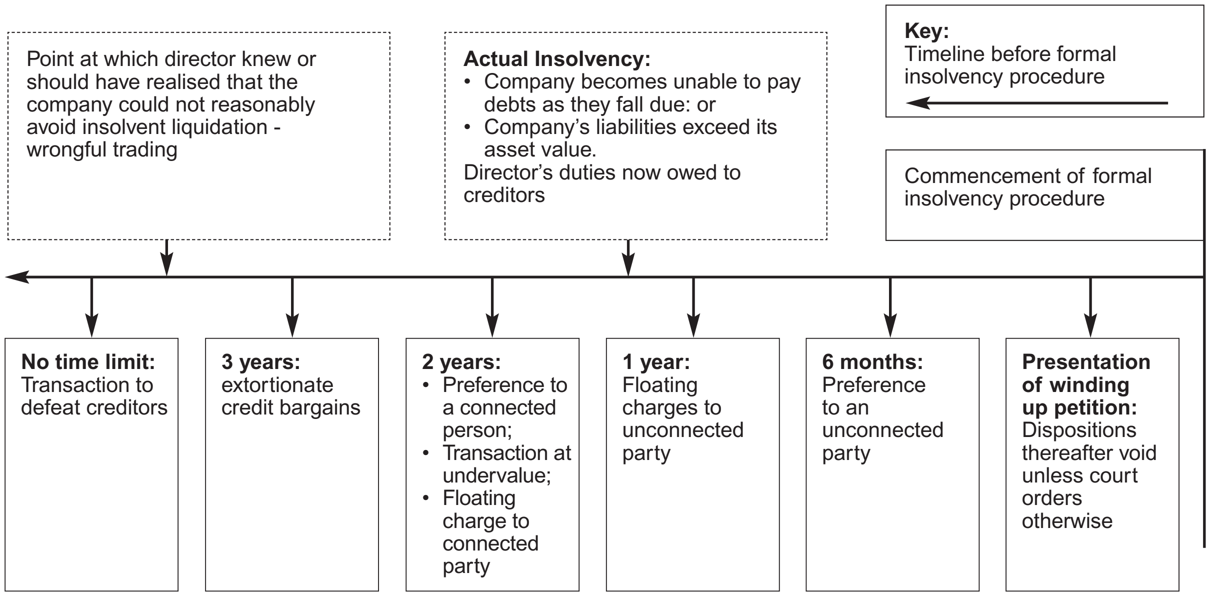
(d) extortionate credit bargains - three years (section 244(2));

(e) transactions defrauding creditors - no time limit (section 423);

(f) dispositions after winding up petition - from date of petition (section 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[5].



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?;

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4 All statutory references in this chapter are to the Insolvency Act 1986 (as amended) (IA 1986) unless stated otherwise.

5 Effectively connected persons comprise directors (or "shadow" directors upon whose instruction 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.

(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[6]

(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 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[7]. The elements of wrongful trading are as follows:

(i) it applies to directors or "shadow directors"[8] 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[9];

(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[10]. 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[11]. However, the essence of the law is to compensate creditors for the loss caused by the director's conduct.[12]

(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.

(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[13] 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[14].

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[6] Section 214 IA 1986

[7] 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. But the wrongful trading provision does ensure directors focus their minds on the impact their actions and decisions have on creditors during this time.

[8] 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 3.2.2 - 3.2.4.

[9] Which will depend upon rational expectations as to the future: *In the matter of Langreen Ltd (in Liquidation)* (2011) LTL 26/10/2011. Examples of failures to act on rational expectations as to the future include where there has been "confusion between aspiration and actuality" and "willfully blind optimism": *Re Onslow Ditching Ltd* [2011] EWHC 257 (Ch) and unreasonable hope that "everything would turn up": *Re Singla v Hedman* [2010] EWHC 902 (Ch).

[10] The court stressed the objective element of the test in *Singla v Hedman* [2010] EWHC 902 (Ch) and refused to accept the argument that there was a lower standard of responsibility in an inherently risky business (such as the film industry).

[11] *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC S20.

[12] 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] See also *Re Produce Marketing Consortium Ltd (No. 2)* [1989] BCLC 520 and *Re Bangla Television (in liquidation), Valentine v. Bangla Ltd* [2009] EWHC 1632 (Ch).

[13] In *Re Cubelock* [2001] BCC 523, the court stated that 'the law has to leave room for cases where it was acceptable for the directors to take the view that their company, though insolvent in balance sheet terms for the present, was going to trade its way back into profit so that all creditors would be paid". In *Re Hawkes Hill Publishing Co Ltd (in liquidation)* [2007] All ER (D) 422 the court stated that answer to whether a director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation did not depend on a snapshot of the company's financial position at any given time but on rational expectations of what the future might hold; directors were not expected to be clairvoyant. Confirmed in *Earp v. Stevenson* [2011] EWHC 1436 (Ch). Care should also be taken not to invoke hindsight and proper regard must be had to the difficult choices which often confront directors when deciding whether to continue to trade and on what basis (*In the matter of Idessa (UK) Ltd (in liquidation) Burke v Morrison* [2011] EWHC 804).

[14] For example, *In the matter of the Continental Assurance Company of London plc (in liquidation)* [2001] All ER (D) 229.

2.2 Fraudulent trading[15]

(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 a liquidation in progress[16];

(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[17] 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[18].

(b) (i) Liability may be criminal[19] 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[20].

(iii) As with wrongful trading, there should be an element of proportionality albeit that the court's discretion is very wide.[21]

(iv) There is no specified period.

(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. However, simply turning a blind eye to the obvious may amount to fraudulent trading. But 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[22]

(a) Personal liability will attach to a past or present "officer"[23] 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.

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15 Section 213 IA 1986.

16 Except if the action for fraudulent trading is brought under section 993 Companies Act 2006.

17 In *Bilta (UK) v Nazir and others* [2012] EWHC 2163, it was held that "any person" (to which section 213 IA 1986 applies) was not confined to persons within the jurisdiction (ie to those involved in fraudulent trading activities in England), but that section 213 has extra-territorial effect.

18 *Re Bank of Credit and Commerce International SA (No.2), Banque Arabe et Internationale D'Investissement SA v Morris* [2000] All ER (D) 1437.

19 Section 993 Companies Act 2006. Section 213 IA 1986 is concerned only with civil liability.

20 *Morphitis v Bernasconi* [2003] All ER (D) 33 and *Morris v Bank of India* [2004] All ER (D) 378, but may include an element of interest in any award. However, a punitive element may be included if the action is brought under section 993 Companies Act 2006.

21 The liability of each director should be fixed separately but the contribution to be made by each director need not be the same and the court can declare that liability should be joint and several: *Re Overnight (No 2)* [2010] 613.

22 Section 206 IA 1986.

23 There is no specific definition of an "officer" in either the IA 1986 or the Companies Act 2006. However, section 1173(1) Companies Act 2006 (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 79 to paragraph 3.3.1 below.

(v) The following defences exist:

(A) that there was no intent to defraud or to conceal[24]; and

(B) that there was no intent to defeat the scheme of the insolvency law.

2.4 Transactions in fraud of creditors[25]

(a) This offence is made out if an officer[26] 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 two 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 the winding up[27]

(a) A past or present officer[28] 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.

(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[29]

(a) An officer[30] 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.

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[24] 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.

[25] Section 207 IA 1986.

[26] See footnote 23 above. A person will only be liable if he was an officer of the company at the time of the winding up.

[27] Section 208 IA 1986.

[28] See footnote 23 above.

[29] Section 209 IA 1986.

[30] See footnote 23 above.

2.7 Material omissions from statement relating to company's affairs[31]

(a) A past or present officer[32] 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.

2.8 False representations to creditors[33]

(a) Any past or present officer[34] 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[35]

(a) A past or present officer[36] 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[37].

(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[38].

2.10 Re-using a prohibited company name[39]

(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 (or a shadow 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.

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31 Section 210 IA 1986.
32 See footnote 23 above.
33 Section 211 IA 1986.
34 See footnote 23 above.
35 Section 212 IA 1986.
36 See footnote 23 above.
37 See *In the matter of Idessa (UK) Ltd (in liquidation) (Burke v Morrison)* [2011] EWHC 804 for an example of misfeasance (and the duties, a breach of which, will constitute misfeasance). Note, however, this section does not create a new liability, just a simpler procedure and a statutory remedy against officers who breach their duties (statutory, common law or fiduciary). See also *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch) for a discussion of when a (sole) director who has caused the company to make a preference payment will be liable for misfeasance. The preference does not automatically mean the director is liable for misfeasance.
38 Section 1157 Companies Act 2006, the predecessor of which (section 727 Companies Act 1985) was considered in *Re Loquitur* [2003] 2 BCLC 442 and *Re MDA Investment Management Ltd* [2005] BCC 783.
39 Sections 216 and 217 IA 1986.

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[40] and civil[41].

(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 five 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 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[42];

(B) for an interim period, whilst an application is made to the court[43]; 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[44].

2.11 Destroying, mutilating etc. company documents[45]

(a) Any officer[46] 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 Fiduciary duties owed to the company

(a) The general fiduciary duties of a director are predominantly set out in the Companies Act 2006. Prior to 1 October 2007, the duties of directors were derived from the common law, equitable principles and some statutory provisions in the Companies Act 1985. The Companies Act 2006 now includes a statutory statement (codification) of the general duties of directors. These duties came into effect in two tranches on 1 October 2007 and 1 October 2008.

The key aim of codification was to make the law regarding directors’ duties more accessible. With a couple of exceptions, the stated intention was principally to restate rather than change the previous law. Regard will continue to be had to the corresponding common law and equitable principles (both as applied to directors’ duties prior to codification and as developed in other areas of law on an ongoing basis) when interpreting and applying the general duties. In addition, as there has been no codification of the remedies for breach of the general duties, the consequences of breach will be the same as they would have been for breach of the previous corresponding duties.

The codified duties are:

(i) duty to act within powers[47];

(ii) duty to promote the success of the company for the benefit of its members as a whole[48];

[40] Section 216 IA 1986.
[41] Section 217 IA 1986.
[42] Rule 4.228 Insolvency Rules (“IR”) 1986.
[43] Rule 4.229 IR 1986.
[44] Rule 4.230 IR 1986.
[45] Section 450 Companies Act 1985 (as amended by section 1124 Companies Act 2006).
[46] See footnote 23 above.
[47] Section 171 Companies Act 2006.
[48] Section 172 Companies Act 2006.

(iii) duty to exercise independent judgment[49];

(iv) duty to exercise reasonable care, skill and diligence[50];

(v) duty to avoid conflicts of interest[51];

(vi) duty not to accept benefits from third parties[52]; and

(vii) the duty to declare interest in proposed transaction or arrangement[53].

In exercising the duty to promote the success of the company, directors must have regard (amongst other matters) to: the likely consequences of any decision in the long term, the need to foster the company's business relationships with suppliers, customers and others, the company's employees and the environment (that is, other stakeholders).

However, the duty to promote the success of the company has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interest of creditors of the company. This is a reference to the common law rule that, once a company becomes insolvent, the interests of the creditors over-ride those of the members of 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[54].

To what extent directors of companies that continue trading during the "twilight" period are required to take account of the interests of the various other stakeholders has not yet been considered by the courts. The position under the Companies Act 2006 was left deliberately open with the intention of leaving the law to develop in this area. No doubt, the answer will very much depend on the facts and the exercise of commercial judgment based on those facts.

(b) (i) Liability for breach of these duties is civil. Section 178 of the Companies Act 2006 provides that the consequences of breach (or threatened breach) of sections 171 to 177 (the statutory duties referred to above) are the same as would apply if the corresponding common law rule or equitable principle applied. The duties in those sections (with the exception of the duty to exercise reasonable care, skill and diligence) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors.

(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 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[55].

(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[56].

2.13 Standard of duties owed by executive and non-executive directors

2.13.1 A director must exercise reasonable care, skill and diligence in fulfilling his functions[57]. The standard expected is assessed by reference to both an objective test and a subjective test, as a director has to exercise the care, skill and diligence that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (the objective test), and (b) the general knowledge, skill and experience that the director has (the subjective test). So, the director must meet the higher of these two tests.

A person should not take on a directorship unless he is sufficiently qualified or experienced to be able to fulfil the functions which a director in that position might reasonably be expected to carry out. In addition, if a director happens to have a greater level of knowledge, skill or experience than might reasonably be expected of someone carrying out his functions, he will have to meet that higher standard. It is also important that the board, as a whole, is comprised of directors possessing the whole range of necessary skills.

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49 Section 173 Companies Act 2006.
50 Section 174 Companies Act 2006.
51 Section 175 Companies Act 2006.
52 Section 176 Companies Act 2006.
53 Section 177 Companies Act 2006.
54 Confirmed in *In the matter of Idessa (UK) Ltd (in liquidation) Burke v Morrison* [2011] EWHC 804 (Ch) (post the statutory codification of directors' duties), following the pre-codification cases of *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250 and *Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch).
55 Section 1, Civil Liability (Contribution) Act 1978.
56 Section 1157, Companies Act 2006.
57 Section 174 Companies Act 2006.

2.13.2 A board may (subject to the articles) delegate specific tasks and functions to appropriate people (whether directors or others), and trust their competence and integrity to a reasonable extent. Overall responsibility is, however, not delegable. Delegated responsibilities should be supervised to an appropriate extent, and there should be procedures in place for those delegated to report back up to the board. The extent of a director's duty of supervision, and whether it has been discharged, will depend on the facts of each particular case, including the director's role in the management and the natural expectations of the members. Relevant factors may well include the status of the director – e.g. whether he is an executive or a non-executive director.

2.13.3 The standard of care required from a non-executive director is the same as that required from an executive director. But there will be some differences in the role which a non-executive will be expected to fulfil.[58] So, the required standard may differ in application due to the difference in the role or the functions which non-executives are expected to fulfil. For example, it is commonly acknowledged that executive directors have more day to day responsibility for the running of a company, and non-executive directors cannot generally dedicate themselves to their role on a full time basis[58].

2.13.4 For listed companies, corporate governance developments provide some guidance as to the role that directors are expected to fulfil.

2.13.5 The UK Corporate Governance Code (September 2012) issued by the Financial Reporting Council (FRC) provides guidance on the roles that directors are expected to fulfil. In relation to non-executive directors, a key principle is that they should constructively challenge and help develop proposals on strategy. They should scrutinise the performance of management in meeting agreed goals and objectives, monitor the reporting of performance and satisfy themselves as to the integrity of financial information. They are responsible for determining executive remuneration and have a prime role in relation to appointments and succession planning. They must join with the executives in leading the company, and they must be able to allocate sufficient time to their position to discharge their responsibilities. They also have a key role to play in relation to risk management and internal control (see the FRC Guidance on Internal Control of October 2005 – formerly known as the Turnbull Guidance).[59]

2.13.6 The Guidance on Board Effectiveness issued by the FRC in March 2011 (in place of the old Higgs Guidance) provides detailed guidance on the characteristics of an effective board, and specifically addresses the role to be played in this regard by the chairman, the senior independent directors, executive and non-executive directors. It also places emphasis on the importance of high quality board decision making processes.

2.13.7 An executive director will normally also have a service contract which may provide further clarification regarding his role and duties.

2.14 Incurring further credit

2.14.1 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.

2.15 Liability of directors to disqualification for acts done in the 'twilight zone'

2.15.1 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[60], in practice almost all disqualification orders are made on the basis of conduct evidencing a person's 'unfitness' to act as director[61], 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 automatic disqualification. Disqualification orders can also be made by the court of its own volition 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[62].

2.15.2 Since 1 April 2001, directors against whom disqualification proceedings would have otherwise been brought on the basis of 'unfitness' can instead voluntarily give an undertaking that they will not act as a director or be involved in the formation of a company for a set period of time.[63]

2.15.3 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 7.9.3 below.) There is also, generally speaking, no anterior time 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.

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[58] 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."

[59] To be reviewed and updated by the FRC in 2013.

[60] 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).

[61] Section 6 CDDA 1986.

[62] Section 10 CDDA 1986. It is even possible for the disqualification proceedings and the wrongful trading allegations to be heard at the same hearing.

[63] Section 1A CDDA 1986.

Acts potentially giving rise to a disqualification order

2.15.4 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 (including statutory/codified) 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.

2.15.5 In determining whether a director is unfit, the court considers the cumulative effect of the allegations as are proved against him.

2.15.6 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.

2.15.7 That said, the courts have 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.[64]

Length of disqualification

2.15.8 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:

(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[65];

(b) two to five years' disqualification is justified where the case is, relatively, not very serious[66]; and

(c) a middle 'bracket' of six to ten years for cases falling between (a) and (b)[67].

Statistics show that most of the orders made range from three to seven years.

2.15.9 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. 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.

2.15.10 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.

2.15.11 Other than those who have been formally appointed directors, and save where the conduct on which disqualification is based is a criminal offence[68] or fraudulent trading[69], disqualification may only be made against *de facto* directors, shadow directors[70] 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.

2.15.12 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.

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[64] *Secretary of State for Trade and Industry v Goldberg* [2003] All ER (D) 369.

[65] *Official Receiver v Stern* [2001] All ER (D) 278 and *Re Mea Corporation Ltd* [2006] EWHC 1846 (Ch) are examples.

[66] *Secretary of State for Trade and Industry v Goldberg & McAvoy* [2003] All ER (D) 369 is an example.

[67] *In the matter of Skyward Builders plc (O.R. v Mullarkey)* [2002] All ER (D) 367, *Re Mea Corporation Corporation Ltd* [2006] EWHC 1846 (Ch) and *Secretary of State for Business, Enterprise and Regulatory Reform v Poulter* [2009] BCC 608 are such examples.

[68] Section 2 CDDA 1986.

[69] Sections 4 and 10 CDDA 1986.

[70] Confirmed most recently in *In the matter of UKLI Ltd* [2013] EWHC 680 (Ch).

Duty to co-operate

2.15.13 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 with him[71] 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

2.15.14 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

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.

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".

The two concepts are not mutually exclusive; a person can be both a shadow director and a *de facto* director (with one possibly shading into the other). Both concepts, as discussed below, involve the exercise of real influence in the corporate governance of a company. That influence may sometimes be concealed and sometimes open; in some cases, it may be a mixture of both. Neither the role of a shadow director nor a *de facto* director need extend over the whole range of the company's activities so, for example, a person may assume the functions of a director (a *de facto* director) as regards one part of the company's activities (say, marketing) and give directions to the board (as a shadow director) as regards another (say, finance). The same sort of evidential indicia are likely to be relevant to establishing both shadow and *de facto* directorships (and differences between the two may have previously been overstated by the courts).[72]

[71] Sections 235 and 236 IA 1986.
[72] *Re Mea Corporation Corporation Ltd* [2006] EWHC 1846 (Ch) and *In the matter of UKLI Ltd* [2013] EWHC 680 (Ch).

De facto directors

3.2.2 A *de facto* director is one who presumes to act 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). A *de facto* director must have been part of the corporate governing structure and participated in directing the affairs of the company in relation to the acts/conduct complained of; he must either have been the sole person directing the affairs of the company or a substantial or predominant influence and force (in order to evidence influence); his functions/acts should be ones that could only be undertaken by a director (and not ones which could have been performed by a manager or other employee); it will be relevant but not necessary that he (or others) held himself out as a director and his role may relate to part only of the affairs of the company so long as that part is the part of which complaint is made.[73] Ultimately it will be a question of fact whether a person is a *de facto* director, taking all the circumstances into account. "Director" is defined in section 250 of the Companies Act 2006 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, by contrast, a creature of statute 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)". Unlike a *de-facto* director, a shadow director does not claim or purport to act as a director; on the contrary, he claims not to be a director. However, as noted above, the two concepts are not mutually exclusive.

There is a similar definition for Companies Act purposes in section 251 of the Companies Act 2006.

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.[74]

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73 *In the matter of UKLI Ltd* [2013] EWHC 680 (Ch), *Gemma Ltd v Davies* [2008] BCC 812 and *Holland v Commissioners for Her Majesty's Revenue and Customs* [2010] UKSC 51. The *Holland* decision by the Supreme Court contains a helpful discussion of what constitutes a de facto director (and a review of previous case law) and in particular considers when a individual (sole) director of a corporate director will be deemed a de facto director of the company in respect of which it is a corporate director.

74 See also *Ultraframe (UK) Ltd v Fielding* [2005] WL 1801204 (27 July 2995) (Ch D) at page 222/223 "…where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director."

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”[75].

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.

[75] *Ultraframe (UK) Ltd v Fielding* [2005] WL 1801204 (27 July 2005) (ChD).

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[76], there is no specific statutory definition of this term. Instead, the different persons who are covered by the term will usually depend on the statutory provision in question. Section 1173(1) of the Companies Act 2006 states that the term "officer" includes a director, manager[77] or secretary of a company. Others who may be officers of a company include auditors[78] and administrators. Receivers, including administrative receivers, will not be officers of a company[79].

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[80] (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.[81] 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.[82]

3.4.3 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. 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.

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	Same as for director
Restriction on re-use of company name	Shadow director within 12 months of company's liquidation	Same as for director

[76] See explanation of definition of "officer" in footnote 23 to paragraph 2.3 above.

[77] The concept of a "manager" is not defined in either the Companies Act 2006 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* 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".

[78] 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.

[79] *Re B Johnson & Co. (Builders) Limited* [1955] Ch 634.

[80] 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.

[81] Section 213(2) IA 1986; see paragraph 2.2 above.

[82] *BCCI v Christopher Morris* [2000] All ER (D) 1437.

Offence / activity	Persons liable	Extent of liability
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
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
Disqualification	Any person occupying the position of director, by whatever name called (including shadow director for the purposes of sections 6-9 of CDDA 1986)[83]	Same as for director

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.[84] This reflects the weakened state of a 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[85]:

(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;

[83] Sections 6(3C) and 22(4) CDDA 1986; *Re Mea Corporation Ltd; Secretary of State for Trade and Industry v Aviss* [2006] EWHC 1846(Ch).

[84] 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.

[85] 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.

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[86]

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:

(1) The company is in liquidation or administration and an application is made by the liquidator or administrator (section 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 (sections 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) (section 240(3)).

(3) The company was unable to pay its debts within the meaning of section 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[87]) 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 (section 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 (section 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 (section 436). In Phillips v Brewin Dolphin [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.

[86] Section 238 IA 1986. All statutory references in this question 4 are to the IA 1986 (as amended) unless stated otherwise.

[87] For commentary on the cashflow and balance-sheet test, refer to *BNY Corporate Trustee Services Ltd v. Eurosail-UK 2007 – 3BL plc & others* [2011] EWCA Civ 227.

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.[88]

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 the what the company is providing in exchange) have to be considered. In Phillips v Brewin Dolphin [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 (section 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 (section 241(2) and (3)).

It has also been suggested that a defence of good faith change of position (eg where a recipient of a gift of money has, in good faith, spent the money received) may in exceptional circumstances be available, although the legislation does not refer to this.[89]

Examples of financial transaction that may fall within the section

4.3.8 In 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 was not a transaction at an undervalue but merely attaches a particular liability to a particular asset. 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. Ordinarily, the mere creation of security over the company's assets does not deplete them or diminish their value. That said, there may be circumstances where, on the facts, the creation of security may be regarded as a transaction at an undervalue[90].

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[91]

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 thing had not been done and 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 (section 239 (1) and (2))

(2) The company gave the preference within a vulnerability period ending with the 'onset of insolvency' (section 239(2))[92]. 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[93] (other than by reason of being its employee) the vulnerability period is two years; and (section 240(1)(a));

(b) in the case of a preference given to any other person, the vulnerability period is six months (section 240 (1)(b)).

[88] *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.*

[89] Applied (but subject to much criticism) in the context of a section 423 (transactions defrauding creditors) application but the principle could in theory apply to a transaction at an undervalue application: Sales J *in 4 Eng Ltd v Harper* [2009] EWHC 2633 (Ch) and again, following his own *4 Eng* judgment, in *Trustee in Bankruptcy of Gordon Claridge v Claridge* [2011] EWHC 2047.

[90] *Hill v. Spread Trustee Company Ltd* [2006] EWCA Civ542 where there was no evidence of any forbearance by the secured creditor in return for the borrower granting security in respect of its existing indebtedness.

[91] Section 239 IA 1986.

[92] This concept is the same as for transaction at undervalue - see paragraph 4.3.2(2) above.

[93] See answer to Question 1 at paragraph 1.1.7, footnote 5 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).[94]

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 (section 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 (section 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[95].

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 withdrew its support, was liquidation) was not voidable as a preference 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 at the time the preference is given (otherwise than by reason of being its employee), 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)[96].

4.5 Transactions defrauding creditors[97]

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 (section 425(2)). It has also been suggested that a defence of good faith change of position (eg where a recipient of a gift of money has, in good faith, spent the money received) may be available, although the legislation does not refer to this[98].

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94 See paragraph 4.3.2(3) above.
95 See, for example, *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch).
96 *Re Sonatacus Ltd* [2007] All ER (D) 203 (CA).
97 Section 423 IA 1986.
98 Sales J *in 4 Eng Ltd v Harper* [2009] EWHC 2633 (Ch) and again, following his own *4 Eng* judgment, in *Trustee in Bankruptcy of Gordon Claridge*

4.6 Extortionate credit transactions[99]

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 (section 244(1) applying section 238(1)) and the administrator or liquidator brings an action;

(3) the transaction is or was 'extortionate'; and

(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.[100]

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 (section 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 (section 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[101]

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[102] 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[103] (section 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" (section 245(3)(b)); or

(c) in the case of a charge created in favour of any person, between the presentation of an application for an administration order and the making of an order on that application (section 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 (section 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 section 123[104] or became unable to do so in consequence of the charge (section 245(4)).

4.7.3 Under section 245(2), 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;

v Claridge [2011] EWHC 2047.

[99] Section 244 IA 1986.

[100] That is, a winding-up order is made or resolution of members passed for voluntary winding-up.

[101] Section 245 IA 1986.

[102] Section 245 IA 1986 does not apply to any charge created or otherwise arising under a security financial collateral arrangement: regulation 10 (5), Financial Collateral Arrangements (No 2) Regulations 2003.

[103] See the explanation of that concept at paragraph 4.3.2(2) above.

(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 (section 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 creation of the security. Drawings out of the account, even if replaced by payments into the account, represent new credit for these purposes[105] - 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 fiduciary 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 fiduciary duties to the company. 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.[106]

4.9 Disclaimer of onerous property[107]

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[108].

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 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.

4.10 Dispositions of the company's property made after the commencement of winding-up[109]

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[110]. 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.[111] The provision does not, however, give rise to any cause of action against the directors for any loss which the company may have sustained as a result.

[104] See the explanation of that concept at paragraph 4.3.2(3) above.
[105] This is known as the rule in *Clayton's Case* (1816) 1 Mer 572.
[106] See paragraphs 2.12 - 2.13 above for a full explanation.
[107] Section 178 IA 1986.
[108] A liquidator cannot disclaim, as onerous property, any financial collateral arrangement: regulation 10 (4) Financial Collateral Arrangements (No 2) Regulations 2003.
[109] Section 127 IA 1986.
[110] This provision does not apply to any property or security interest subject to a disposition or created or otherwise arising under a financial collateral arrangement or to prevent a close-out netting provision taking effect in accordance with its terms: regulation 10 (1) Financial Collateral Arrangements (No 2) Regulations 2003.

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[112]

4.11.1 English law operates a system of registration of security created by English companies.[113] 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 obligation to register the charge, 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 The registration requirements are set out in Part 25 Chapter A1 to the Companies Act 2006 (sections 859A to 859Q), with effect from 6 April 2013.[114] These requirements simplify the registration process so that, subject to a few limited exceptions, all security must be registered (and not just security over certain categories of property, as was the case previously). The exemption from registration in respect of "financial collateral" continues to apply.[115]

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 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. Firstly, 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[116]. 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.

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[117]

(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 omissions 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 993 Companies Act 2006

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111 *Re Tain Construction Ltd (Rose v AIB Group (UK) plc* [2003] All ER (D) 91.

112 Part 25 Companies Act 2006.

113 An overseas company with a registered place of business in England which grants security over assets situate in England used to be required to register the security under the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009. This requirement was removed with effect from 1 October 2011 by The Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2011, but registration is still required in respect of security created prior to 1 October 2011.

114 The former registration process under Part 25 of the Companies Act 2006 (repealed) will continue to apply to charges created prior to 6 April 2013.

115 Security over "financial collateral" (very broadly, cash, shares, tradeable bonds and credit claims) is exempt from registration 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).

116 Section 218 IA 1986.

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.

Activity / transaction	**Person able to bring proceedings**
Misfeasance	Liquidator, Official Receiver, a creditor or, with leave of the court, a contributory[118]
Fraudulent Trading	Liquidator only[119]
Wrongful Trading	Liquidator only
Personal liability for unlawful re-use of company name	DPP[120]
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"[121]
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

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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?

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 IA 1986 is primarily compensatory.[122] 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 IA 1986 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[123]	If tried by a jury, the penalty is up to ten years imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to 12 months and/or a fine up to the statutory maximum (currently £5,000)*.

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[117] All section references are to the Insolvency Act 1986 unless specified otherwise.

[118] 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.

[119] An action brought under this provision is for a contribution towards the assets of the company. Criminal proceedings will be brought under section 993 Companies Act 2006.

[120] Liability is automatic if the criminal offence is proved. No further or specific application need be made by or on behalf of the company.

[121] A "victim" is defined as being a person who is, or is capable of being, prejudiced by the relevant transaction.

[122] Based on *Morphitis v Bernasconi* [2003] All ER (D) 33 which, in the context of fraudulent trading, held that the court's order may not include a punitive element. Hence, it is doubtful that this may form part of a wrongful trading order.

Offence	Remedy available
Fraudulent trading[124]	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.
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.
Destroying, mutilating etc company documents including making an omission in a document[125]	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 duty	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[126]	The court may order disqualification for a period of between 2 and 15 years. There is no financial penalty.

[123] Under Section 993 Companies Act 2006 - criminal liability.
[124] Under Section 213 IA 1986 - civil liability requiring a director to contribute to the assets of the company for loss caused.
[125] Section 450 Companies Act 1985, as amended by section 1124 Companies Act 2006.

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 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 (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[127]	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. 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.

[126] Section 6 CDDA 1986.

Offence	Remedy available
Extortionate credit transactions[128]	The impugned transaction may be set aside or the court may make an order to vary 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[129]	The court can declare that the floating charge is invalid in whole or in part.

Under the Legal Aid, Sentencing and Punishment of Offenders Act 2012, a fine payable on summary conviction that is currently capped at the statutory maximum (£5,000) will become a fine of an unlimited amount. The section of this Act which will make this change is not yet in force.

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

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[130].

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'[131]. 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

[127] 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.
[128] Section 244 IA 1986. See explanation of these provisions of this section in the answer to question 5. Liability is civil.
[129] Section 245 IA 1986. See explanation of these provisions in answer to Question 4. Liability is civil.
[130] 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.
[131] The Official Receiver is a civil servant from The Insolvency Service, an agency operating under the aegis of the Department of Business, Enterprise and Regulatory Reform. He is often appointed liquidator on a winding-up order being made, although where there are assets in the liquidation a

(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:

(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[132]

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.[133]

Sanction

7.2.3 There are no specific sanctions for breach of this section; but the court would use its inherent powers to enforce.

7.3 Obligation to provide information[134]

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

creditors meeting will be likely to appoint a private accountant liquidator.

[132] Section 234 IA 1986.

[133] That is the administrator, administrative receiver, liquidator or provisional liquidator.

(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[135]

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:

(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[136]

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[137]

7.6.1 In a creditors' voluntary liquidation[138] 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[139]

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).

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[134] Section 236 IA 1986.

[135] Section 131 IA 1986. Equivalent obligations are imposed by section 2(3)(b) IA 1986 where a company is subject to a voluntary arrangement, section 47 IA 1986 if it is in administrative receivership, para 47 of Schedule B1 to the IA 1986 if in administration and sections 99 and 95(3)(a) IA 1986 if in voluntary liquidation.

[136] Section 133 IA 1986.

[137] Rules 4.39 and 4.40, IR 1986.

[138] 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.

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.[140] Accordingly, section 433 IA 1986 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[141]. In civil proceedings, however, the use of compelled evidence does not per se mean that a hearing is unfair.[142] It would be a matter for the defendant to raise, as he thought fit, at the civil proceedings.

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.[143] 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[144]. 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.[145]

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.[146]

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139 Section 208 IA 1986.

140 *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). But, it is only for the English court to control the use made of compelled statements in criminal proceedings before the English court (and not their use in foreign criminal proceedings): *Rottmann v Brittain* [2009] EWCA Civ 473.

141 Amended by the Youth Justice and Criminal Evidence Act 1999 with effect from 14 April 2000.

142 *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."

143 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.

144 *Re Westminster Pty Management Ltd, Official Receiver v Stern* (ibid).

145 *Slinn v UK*, 26th June, 1996.

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[147]. 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.[148]

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[149] 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 [150] 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[151].

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

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146 See *Fayed v UK* (1994) 18 EHRR 393.

147 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 property within the bankrupt estate.

148 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).

149 And the European Court of Human Rights has 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.

150 *Walker v Daniels* [2000] 1 WLR 1382.

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[152].

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[153]. 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[154]. 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.[155]

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[156].

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.[157] 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.

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[158].

8.2.2 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 a decision of a county court (whether made by a District Judge, a Recorder or a Circuit Judge) or of a Registrar in insolvency proceedings lies to a Judge of the High Court. An appeal from a decision of a Judge of the High Court, whether at first instance or on appeal, lies to the Court of Appeal. A first appeal, in each case, is subject to the permission requirements of CPR Part 52, rule 3. An appeal from a decision of a Judge of the High Court which was made on a first appeal requires the permission of the Court of Appeal[159].

8.2.3 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.

8.2.4 It may also be possible to appeal civil proceedings based on breach of the director's duties (which are not insolvency proceedings)[160].

QUESTION 9

9. Foreign corporations

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

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151 *R v Kearns* [2002] All ER (D) 363.

152 Section 9 of the Limitation Act, 1980. *Re Overnight Ltd* [2009] EWHC 601 (Ch) held that a cause of action under section 213 IA 1986 (fraudulent trading)_does not arise until the liquidator is appointed as only a liquidator can bring an action for fraudulent trading. The same should apply in respect of wrongful trading. See also *Re Farmizer (Products) Ltd* (1997) BCC 655.

153 Section 21(3) of the Limitation Act 1980.

154 Section 21(1) of the Limitation Act 1980. *Belmont Finance v Williams (No. 2)* [1980] 1 AER 393.

155 *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266.

156 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 14B 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.

157 Section 7(2) CDDA 1986.

158 Rule 7.47(1) of the IR 1986.

159 Paragraph 19 of the Insolvency Proceedings Practice Direction (Feb 2012) and rule 7.47(2) of the IR 1986.

9.1 Introduction

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 English insolvency law 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 although, in appropriate cases, a foreign office-holder might be able to bring certain English insolvency law actions against foreign company directors pursuant to section 426 IA 1986 or the Cross Border Insolvency Regulations 2006 without English insolvency proceedings having been commenced against the foreign company.

A foreign company may be wound up or made subject to administration proceedings in England in, inter alia, the following circumstances:

(a) the foreign company is a company to which the EC Regulation on Insolvency Proceedings (see below) applies and has its "centre of main interests" or an "establishment" in England;

(b) the foreign company may be wound up under section 221 IA 1986 as an "unregistered company";

(c) the foreign company is one in respect of which a winding up or administration proceedings could be opened pursuant to an application under section 426 IA 1986;

(d) the foreign company is incorporated in Norway, Iceland and Liechtenstein;

(e) the foreign company may apply for recognition under the Cross-Border Insolvency Regulations 2006.

9.2 Foreign company to which the EU Regulation on Insolvency Proceedings applies

9.2.1 On 31 May, 2002, the EC Regulation on Insolvency Proceedings[161] (the Regulation) came into force across the European Union (with the exception of Denmark)[162] The Regulation applies only to companies with their "centre of main interests" (see below) in the European Union; in respect of such companies, 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.

9.2.2 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. Both liquidation and administration proceedings may be opened as main proceedings in England.

(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 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 and administration proceedings (but only if for the purpose of a winding up, known as 'winding up through administration') can be opened as secondary proceedings in England.

9.2.3 Accordingly, if a company has its CoMI or establishment in England, it may (notwithstanding that the company is incorporated elsewhere) become subject to liquidation and administration proceedings in England.

9.2.4 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[163] 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 (that is, 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 company which is subject to the Regulation.[164]

[160] CPR Part 52.3 sets out the standard permission requirements.

[161] Council Regulation (EC) No 1346/2000 of 29 May 2000.

[162] The Regulation now also applies to the countries that acceded to the European Union on 1 May 2004.

[163] "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.

[164] 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, should 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 (although section 212 IA 1986 could be invoked by an English liquidator to enforce local fiduciary duties). Equally, director disqualification proceedings under the CDDA 1986 may not apply to directors of a foreign corporation to which the Regulation applies. 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. This approach accords with that adopted by the German courts in the Regional Court of Kiel 10.S.44.05 April 20 2006. (Contrast this with the position of a foreign company to which the Regulation does not apply but which may become subject to English insolvency proceedings under section 221 IA 1986 or pursuant to a section 426 request – refer to paragraphs 9.4.3 and 9.4.4 below, the

9.2.5 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.

9.2.6 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.

9.2.7 Where a foreign company has an establishment but no CoMI in England, secondary proceedings can be opened in England but the effect of those proceedings will be restricted to the assets located in England[165]. English law will apply.

9.2.8 The powers of the liquidator or administrator outlined above will apply to all assets situated in England. Additionally, an office - holder 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[166].

9.2.9 A 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 is that a liquidator in secondary proceedings cannot therefore 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[167]) 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 office-holder 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.

9.2.10 The comments in footnote 168 with regard to the CDDA 1996 director disqualification proceedings apply equally to secondary proceedings opened in respect of a foreign corporation.

9.2.11 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 Winding up of a foreign company as an "unregistered company" under section 221 IA 1986

9.3.1 A foreign company may be wound up in England and Wales, in certain circumstances, as an "unregistered" company[168]. In general, all the provisions of the IA 1986 will apply equally on the winding-up of an "unregistered" company[169]. (see further 9.4.3 and 9.4.4 below)

9.3.2 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 situated 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.

9.3.3 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; where the debt upon which the winding-up petition is founded was incurred within the English jurisdiction; 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 and (in the context of cases on schemes of arrangement of foreign companies) where the company's finance documents are governed by English law. 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.

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caselaw on which predates the Regulation.)

[165] Article 3(2) and (3) of the Regulation.

[166] Article 18(2) of the Regulation.

[167] 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.

[168] Section 220 IA 1986.

9.4 Application under section 426 IA 1986

9.4.1 Under section 426 of the IA 1986, the English court is under a duty to assist, as far as possible, with a request for assistance in matters of insolvency received from a court in any other part of the United Kingdom or from any "relevant country or territory"[170]. This could possibly include a request to wind up or make an administration order in respect of a foreign company.[171] In particular, where the English court receives such a request, the court may apply, in relation to the issues specified in the request, 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 England. 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).

9.4.2 Where it is appropriate to respond to a request to wind up or, more likely, to appoint an administrator over a foreign company, the administrator (or liquidator) so appointed will enjoy the normal powers afforded to an administrator (or liquidator, as appropriate) 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.

9.4.3 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.[172] 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.[173] 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. The same would, prima facie, apply to a foreign company subject to English administration proceedings.

9.4.4 In addition, various provisions of the CDDA 1986 relating to the disqualification of a director may be applied by the English courts to a foreign company subject to English insolvency proceedings by virtue of section 426 IA 1986. 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 2006 or the IA 1986 and which are detailed in the responses to Questions 2 and 3 above.

9.4.5 Section 426 IA 1986 may also be used to request the English court's assistance in bringing clawback proceedings against a director of a foreign company, in which event the laws of either the foreign jurisdiction or England can be applied[174].

9.5 Norwegian, Icelandic and Liechtenstein companies

9.5.1 By virtue of the definition of "company" in paragraph 111(1A)(b) of Schedule B1 to the IA 1986, a company incorporated in Norway, Iceland or Leichtenstein may become subject to English administration proceedings.[175]

9.5.2 "Company" is defined to mean:

(a) a company registered under the Companies Act 2006 in England and Wales or in Scotland,

(b) a company incorporated in an EEA State other than the United Kingdom, or

(c) a company not incorporated in an EEA State but having its centre of main interests in a member State other than Denmark.

9.5.3 Norway, Iceland and Leichtenstein are EEA States but not members of the European Union. Hence, a company incorporated in any of these countries may become subject to administration proceedings even though its centre of main interests is not in England (as is required under the Regulation).

9.5.4 The author is not aware of any cases in which this definition has been relied upon to appoint an administrator to a Norwegian, Icelandic or Leichtenstein company. However, in the event of any such appointment, the administrator would have, prima facie, all the powers referred in section 5 above to enforce the rights and duties of a director (subject to the comments above in 9.4.3 and 9.4.4 in relation to the powers of a liquidator in respect of a foreign company).

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169 Section 221 IA 1986.

170 At the present time, the list of relevant countries or territories are: Anguilla, Australia, The Bahamas, Bermuda, Botswana, Brunei, Canada, Cayman Islands, Falkland Islands, Gibraltar, Hong Kong, Tuvalu and the Virgin Islands, Malaysia, Montserrat, New Zealand, South Africa, St Helena, Turks & Caicos Islands, and the Republic of Ireland.

171 *Re Dallhold Estates (UK) Pty Ltd* [1992] BCC 394.

172 *Re Howard Holdings Inc* [1998] BCC 549; *Bilta (UK) Ltd v Nazir and others* [2012] EWHC 2163.

173 *Re Paramount Airways Ltd.* [1993] Ch. 223.

174 *Rubin and New Cap Reinsurance* [2012] UKSC 46.

9.6 Foreign company able to avail itself of the provisions of The Cross-Border Insolvency Regulations 2006

9.6.1 On 4 April 2006, the UNCITRAL Model Law on Cross-Border Insolvency was implemented in Great Britain by The Cross-Border Insolvency Regulations 2006, SI 2006/1030 (the Cross-Border Regulations). The Cross-Border Regulations enable office-holders in a foreign insolvency (known as the foreign office-holder) to seek recognition of their insolvency in England (and the rest of Great Britain) and, in appropriate circumstances, to commence English insolvency proceedings in respect of the foreign company. Under English law, there is no restriction on the countries (and therefore the foreign office-holder) that may take advantage of the Cross-Border Regulations although, as a general matter, an English court will only have jurisdiction to consider a recognition application if the debtor company has a place of business or assets in Great Britain or the court considers for any other reason that England (or Great Britain) is the appropriate forum to consider the question or provide the assistance requested.

9.6.2 Recognition may be sought in respect of two types of foreign insolvency proceedings:

(a) "foreign main proceedings" which are proceedings taking place in the State in which the debtor has its "centre of main interests" which is not defined but is subject to a rebuttable registered office presumption substantially similar to the presumption in the Regulation; and

(b) "foreign non-main proceedings" which are proceedings taking place in a State where the debtor has an "establishment" which is defined to have a meaning similar to the definition in the Regulation.

The effect of obtaining recognition will depend upon whether the proceedings in respect of which recognition is sought are foreign main or foreign non-main proceedings; relief will apply on either an automatic or discretionary basis.

9.6.3 Upon obtaining recognition, the foreign office-holder is granted a right to bring proceedings under English law (known as an art.23 application) to challenge transactions at an undervalue, preferences, extortionate credit transactions and transactions in defraud of creditors (even if English administration or liquidation proceedings have not been commenced).[176] So, for example, where in a foreign insolvency a transaction at an undervalue or a preference has been made in favour of an English creditor (but it is not appropriate to open English insolvency proceedings) a foreign officeholder can still enforce the anti-avoidance provisions referred to in section 4 above by obtaining recognition of the foreign insolvency proceedings under the Cross-Border Regulations and making an art.23 application. Note, however, that the Supreme Court in Rubin[177] has held that the Cross-Border Regulations cannot be used by a foreign officeholder to enforce in England an anti-avoidance judgment obtained in foreign insolvency proceedings.

9.6.4 Additionally, a foreign officeholder is granted the right under the Cross-Border Regulations to apply directly to the English courts to commence English insolvency proceedings.[178] This right is not conditional upon the foreign officeholder having first obtained recognition of the foreign proceedings in England. However, it is subject to the conditions for commencing such a proceeding being met as a matter of English (or British) insolvency law.

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 (and common) for a director to take out insurance against liability for negligence, default, breach of duty or breach of trust and the company may lawfully pay the premiums[179]. Directors may not exclude their liability for these matters. Further, as a general rule, the company cannot indemnify a director against liability for his negligence, default, breach of duty or breach of trust in relation to the company.[180] However, as an exception to this general rule, the company may provide a director with third party indemnity cover (an indemnity against liability incurred to a person other than the company or an associated company) subject to the indemnity meeting certain qualifying terms (namely, it may not indemnify the director against liability incurred in defending criminal proceedings in which he is convicted, in defending civil proceedings brought by the company in which judgment is given against him or in respect of a fine imposed in criminal proceedings or a sum payable to a regulatory authority in respect of non-compliance with any regulatory requirement)[181].

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. 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 will usually specifically exclude 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[182]. 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.

175 For further commentary on paragraph 111(1A)(b) of Schedule B1 to the IA 1986, refer to Philip Smart's book on 'Cross Border Insolvency'.

176 If English insolvency proceedings are afoot, the permission of the court will be required first and, if the foreign proceedings are non-main proceedings, the court will need to be satisfied that the art.23 application relates to assets that, under the law of England, should be administered in the foreign non-main proceeding.

177 *Rubin and New Cap Reinsurance* [2012] UKSC 46.

178 Art 11 of Schedule 1 to the Cross-Border Regulations.

179 Section 233 Companies Act 2006.

180 Section 232(2) Companies Act 2006 renders void any such indemnity provided by the company (directly or indirectly).

181 Section 234 Companies Act 2006.

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 primarily of the interests of the creditors of their company rather than the shareholders - as it is the creditors' money that is now at risk. 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).

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 reasonable (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.

11.1.2 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.

11.1.3 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.[183] 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.

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 and English and U.S. law are quite different in their approach. In the US, it is a defence to a preference claim that the transaction was entered into in the ordinary course of business and on ordinary terms (i.e. the position is viewed from an objective perspective) whereas, 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,may have few teeth.

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[182] Information obtained from Chubb Insurance Limited, the official insurers recommended by the Institute of Directors.

[183] Although 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.

11.4 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.

FRANCE[1]

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 For the purposes of assessing which transactions are vulnerable to attack (as opposed to possibly giving rise to the directors incurring personal liability), the "twilight" period is known in France as the "suspect period"[2]. Under French law, this is different to the observation period during which the directors undergo supervision and/or direct involvement of a court-appointed administrator, liquidator or receiver, as appropriate. (See further the Appendix below).

1.1.2 The date on which the suspect period is deemed to begin is the date on which the company first became unable to pay its debts as they fell due or, to use the French terminology, the date on which it entered in a state of cessation of payments – a cash-flow insolvency test[3]. The "twilight" period ends on the date on which the court opens formal insolvency proceedings, being either judicial reorganisation or liquidation. In principle, there is no suspect period prior to the safeguard procedure (*procédure de sauvegarde*) as only debtors that are not yet in cessation of payments are permitted to enter safeguard proceedings.[4]

1.1.3 The "twilight" period ends with the opening of judicial reorganisation or liquidation since on this date the court appoints either an administrator or a liquidator who will be involved in and control the management of the insolvent company.

1.1.4 The date on which the company first became unable to pay its debts (and therefore, the date on which the "twilight" period commences) is determined in one of three ways (in each case by the court with jurisdiction over the insolvency proceedings concerned). The court may:

(a) find that the date is the same as the date of the judgment opening the proceedings. In such a case, there is no "twilight" period;

(b) find, as a question of fact, that the date occurred prior to the date of its order to open formal insolvency proceedings (i.e often the date when the filing was made in court);

(c) subsequent to the opening of judicial reorganisation or liquidation, decide (after a prior summons and hearing of the debtor and eventually after ordering an expertise for the purpose of gathering any useful information[5]) to revisit its original decision on the basis of new facts and modify the date of cessation of payments. An application for such a judicial deferral of the date of cessation of payments may be made by one or more of the following: the court-appointed administrator, the *mandataire* judiciaire, the public prosecutor[6] or the court-appointed liquidator as appropriate[7]. The application must be made within one year of the judgment opening the procedure.

[1] This Chapter is up to date as of 10 April 2013 and has been specifically adapted for educational or for information purposes only. As such, the answers are limited to the questions raised and do not go into detail on specific subjects of French insolvency law. The chapter is not intended to be a substitute for professional advice.

[2] Articles L. 632-1 et seq. and L. 641-14 of the French Commercial Code.

[3] Pursuant to Article L. 631-1 of the French Commercial Code, the company is in cessation of payements whenever it is unable to meet its current liabilities with its available funds.

[4] Noting in the event the court determines the debtor is in cessation of payments, regular safeguard proceedings must be converted into formal insolvency proceedings. Indeed, as for the new Rapid Financial Safeguard Procedure, the "Sauvegarde Financière accélérée" (SFA), there is no such "twilight" period.

[5] Commercial chamber of the Cour de cassation, 15 February 2000 n° : 97-16770 & 97-14415.

[6] Article L. 631-8, paragraph 3 of the French Commercial Code.

[7] Article L. 641-5 of the French Commercial Code.

1.1.5 The maximum duration of the "twilight" period is 18 months[8]. This means that acts passed by the company 18 months before the opening of the procedure can be cancelled. This 18 months period may be extended to 24 months only in the case of transactions for no consideration (see section 1.1.7). If the parties have concluded a settlement (a *conciliation* agreement) approved (*homologué*) by the court (see the Appendix), the date of the cessation of payments cannot be set to a date prior to the date of the court's approval, except in the event of fraud[9].

1.1.6 In the case of conversion into formal insolvency proceedings (i.e. conversion of a safeguard into a judicial reorganisation), any judicial deferral of the date of cessation of payments will need to be brought within one year of the conversion judgment. The court may not set the date of cessation of payments earlier than 18 months prior to the judgment opening the safeguard[10].

1.1.7 With respect to transactions made for no consideration, the court may treat these as null and void if concluded in the six months prior to the date of cessation of payments[11]. Each type of transaction which may be subject to attack and the conditions which would render such a transaction void are considered in Question 4.

1.1.8 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 case of liability is considered in more detail in response to Question 2. In certain circumstances, the risk of liability arises only after the date of cessation of payments. In other circumstances, liability may arise if there is a causal link between the relevant act of the director and the company's difficulties.

1.2 Summary

1.2.1 If a company is cash-flow insolvent and thereafter goes into judicial reorganisation or liquidation, certain specifically defined transactions may or must be declared null and void.

1.2.2 Furthermore, directors and/or others involved in the management of the company may be personally liable for certain types of actions during the "twilight" period or at any other time even after the opening of insolvency proceedings.

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

French law does not address the potential liability of directors and/or others involved in the management of a company in formal insolvency proceedings on the basis of the type of act performed. Rather French law starts from the causes of action available against such persons based on their behaviour. The responses to this question are therefore explained below on the basis of the main types of causes of action available.

2.2 Action *"en responsabilité pour insuffisance d'actif"* (based on the shortfall of assets on the date the court rules on the sanction)

2.2.1 *De jure* and *de facto* directors[12] of the debtor may be subject to personal liability in the case of judicial liquidation proceedings in the event of a shortfall of assets arising as a result of an act of "mismanagement" of the directors. Claiming against the directors for the shortfall of assets is commonly used by liquidators as a means of augmenting the assets available to cover the debts of the insolvent company.

[8] Article L. 631-8, paragraph 2 of the French Commercial Code.
[9] Article L. 631-8 of French Commercial Code.
[10] Article L. 631-8, paragraph 5 of the French Commercial Code.
[11] Article L. 632-1, II of the French Commercial Code.
[12] *De jure* directors who are appointed in accordance with the company's articles of association of the company and with the law. Please refer to Question 3, below for an explanation of *de facto* directors.

For a director to be held personally liable for the shortfall of assets, the following criteria must be met:[13]

(i) there must have been an act of "mismanagement". However, under French law, "mismanagement" is not defined. Instead, it has been left to the relatively broad interpretation of the courts. Each case is determined on its own facts. The most common examples of mismanaging a business are failing to put adequate measures in place whilst operating the business at a loss and the management granting excessive remuneration to itself during financially turbulent times for the company. Other examples of mismanagement include: corporate asset misappropriation (*abus de biens sociaux*[14]), the distribution of fictitious dividends (*distribution de dividendes fictifs*) and management making decisions which prima facie are badly prepared and destined to fail (for example burdensome investment decisions taken in an uncertain and difficult economic climate or acquisitions made as a result of poor negotiations), failure to comply with fiscal legislation (for example failing to comply with compulsory taxation requirements, as a result of a failure to declare tax obligations[15] including the failure of a director to notify the non-compliance with tax legislation by other directors, including, previous directors, even if the failure to comply with fiscal legislation occurred prior to the director's nomination)[16], failure to comply with social legislation (for example, failing to comply with compulsory taxation requirements, as a result of a failure to declare social taxes[17]), favouring one creditor over another (for example, paying a specific creditor who was aware that the debtor was in cessation of payments[18]). Such acts (and many others) that result in a shortfall of assets may be considered as acts of mismanagement and may consequently result in sanctions against individual directors of the company;

(ii) the liabilities of the company must exceed the value of its assets (ie there must be a shortfall of assets), to be assessed at the time the court determines liability. Debts that arise after the opening of judicial liquidation are not included in the company's liabilities for the purposes of this analysis;

(iii) the claimant must demonstrate that the act or acts of mismanagement contributed to the shortfall of assets. However, the act(s) need not have been the sole and exclusive, unique or principal cause of the shortfall. It is enough that the act or acts of mismanagement were one of a number of causes that contributed to the shortfall. The question as to how much an act or acts contributed to the shortfall is for the courts to decide. The courts' decision is based on the facts of each case and this can sometimes lead to varied and unpredictable results. Furthermore, the acts and omissions of one director do not automatically exonerate the other directors because, as stated above, an act of mismanagement is not required to be the sole and exclusive cause of the asset shortfall;

(iv) at least a partial[19] causal link must exist between the act of mismanagement and the shortfall of assets[20].

Pursuant to Article L 651-3 of the French Commercial Code, only the liquidator or the public prosecutor has the right to bring a claim for the shortfall of assets and within three years from the date of the court decision opening the judicial liquidation of the company[21]. But should the liquidator decide not to bring such a claim, the majority of the court-appointed *contrôleurs* (a creditor representing the interests of all creditors, usually a large creditor) will have the right to bring this claim[22].

2.2.2 If (i) to (iv) of 2.2.1 above are satisfied:

(i) it is for the court to decide, on the facts presented before it, whether the directors are to be held personally liable for the shortfall of assets;

(ii) directors found liable will be required to pay damages, which will form part of the assets of the debtor available for distribution to creditors. It is up to the court to decide, on the basis of the seriousness of the act of mismanagement and the strength of the causal link, whether the director in question should pay damages or not. That is, even if (i) to (iv) of 2.2.1 above are satisfied, the court is not required to impose a sanction;

(iii) it is up to the court to decide the amount of damages that the director must pay. The amount is not necessarily proportionate to the level of contribution caused to the debts of the company. The maximum amount of damages that a director can be ordered to pay is the total liabilities of the company less the available assets. If more than one director is liable, they may be held severally liable if the court considers this reasonable and justifiable;

(iv) there is no specific time period prior to the commencement of formal insolvency proceedings during which an act of mismanagement must have occurred. In practice, the period is limited by the need for there to be a causal link between the act of mismanagement and the insolvency of the company. In the vast majority of cases, the last possible act is the failure to file the declaration of cessation of payments within the requisite (45) days after the date of cessation of payments[23];

(v) other than the general defence of absence of act of mismanagement (including, in the case of an alleged *de facto* director, absence of the person's implication in the management of the company) or absence of causal link or a shortfall of assets, there are no specific defences to this allegation;

(vi) the claim must be brought within three years from the date of the court decision opening the judicial liquidation of the company[24].

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13 Article L. 651-2 of the French Commercial Code.
14 Commercial chamber of the Cour de cassation.21 february 2012 n° 11-13.513.
15 Commercial chamber of the Cour de cassation 13 November 2007, n°06-13.212.
16 Paris, 3° ch.A, 16 mai 2006, RG°2005/15820.
17 Commercial chamber of the Cour de cassation13 November 2007, n°06-13.212.
18 Commercial chamber of the Cour de cassation 11 June 1996, n°94-16.067.
19 Commercial chamber of the Cour de cassation, 17 February 1998, no 95-18.510.
20 Commercial chamber of the Cour de cassation, 14 May 1991, no 89-19.081.
21 Commercial chamber of the Cour de cassation, 6 June 1995, no 91-21.173.
22 Commercial chamber of the Cour de cassation, 11 May 1993 : Bull. civ. IV, n°187; D. 1993. IR 195.
23 Pursuant to article L. 631-1 of the French Commercial Code, the company is in cessation of payments whenever it is unable to meet its current liabilities with its available funds.
24 Commercial chamber of the Cour de cassation, 19 May 2004, no 02-11.199.

2.3 Liability for the debts of the company

Since the entry into force of law n°2008-1345 dated 18 December 2008, claims against directors having committed faults pursuant to Article L.624-5 of the French Commercial Code may only be brought in judicial reorganisation or judicial liquidation which were opened prior to 15 February 2009. This permitted the court to hold an individual *de jure* or *de facto* director liable for the debts of the insolvent company if there was a fault pursuant to the old Article L.624-5 of the French Commercial Code and if the fault had a causal link with the cessation of payments.

2.4 Personal bankruptcy – prohibition on management

2.4.1 Personal bankruptcy is a professional sanction which, in essence, prevents a director from being involved in the management, administration or control of any commercial or business entity or any company engaged in economic activity. In some ways, it is similar to director disqualification in the UK but in addition, French personal bankruptcy may prevent a director from being elected in any public election and holding any public function (see below). An individual *de jure* or *de facto* director may be subject to personal bankruptcy during the course of judicial reorganisation or judicial liquidation against the company[25]; personal bankruptcy may not therefore be sought during safeguard proceedings nor accelerated financial safeguard proceedings[26]. The sanction of personal bankruptcy may be imposed on an individual as a result of them:

(i) abusively (wrongfully) carrying out an unprofitable business activity that would necessarily lead to the company's insolvency;

(ii) misappropriating or concealing all or part of the assets of the company or fraudulently increasing the liabilities of the company;

(iii) committing any of the violations listed under Article L. 653-4 of the French Commercial Code which are as follows:

(a) using property of the company as his or her own. This concept covers a wide range of behaviours including, 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) undertaking commercial transactions for his or her own interests in the name of the company. This typically applies to directors who abuse their majority position in the company and manage the company for their own personal interests;

(c) using property or assets of the company in a manner contrary to the company's own interests for personal ends or the ends of another company in which the director has a direct or indirect interest. This type of behaviour is in practice very similar to that covered by (b);

(d) pursuing abusively and for personal ends a loss-making activity which would inevitably lead to the company falling into a state of cessation of payments. This concept typically covers 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) 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, where the director may seek to organise the insolvency of the company or to deal with the assets of the company to the detriment of the company's creditors.

(iv) carrying out a management role in the company when prohibited from doing so;

(v) with the intention of avoiding or delaying the opening of formal insolvency proceedings, entering into purchases with a view to resale at below market price or using other inappropriate means to obtain funds;

(vi) entering into, for the account of a third party, and without consideration, undertakings judged to be too significant or important at the time given the situation of the company;

(vii) paying or causing to be paid, after the date of cessation of payments, one creditor in preference to others;

(viii) intentionally failing to co-operate with the good progress of the insolvency proceedings; and/or

(ix) keeping accounts that are fictitious, manifestly incomplete or irregular according to applicable law, not keeping accounts when required by applicable law, or causing accounting books and records to disappear.

Although the provisions of the law do not specifically require, typically there must be a link (if not the cause) between the wrongful act in question and the insolvency of the company – apart from those cases where, by definition, no link is necessary, for example, in respect of (vii) and (viii) above.

2.4.2 If any of (i) to (ix) are satisfied:

(i) the court is not required to impose sanctions on the director liable. If it does, liability is civil, whether the sanction imposed is personal bankruptcy or prohibition on management (see further below);

(ii) although liability is civil, certain characteristics of personal bankruptcy are penal in nature:

[25] Article L. 653-1 of the French Commercial Code.
[26] Article L. 628-1 of the French Commercial Code.

(a) the sanction of personal bankruptcy carries with it a prohibition on directly or indirectly managing, administrating and/or controlling a commercial business or any form of company which has an economic business activity. Furthermore, the court may also prohibit a director from carrying out certain professions or functions which have a public nature (for example, the judiciary, the legal profession, and activities as a financial intermediary, insurance agent, etc.), meaning that a director sanctioned by personal bankruptcy may not take part in public elections;

(b) alternatively, the court may impose a prohibition on management, which is a diluted form of personal insolvency. The most severe form of this sanction is the prohibition on managing, administrating and controlling a commercial business or any form of company which has an economic business activity.

(c) It must be noted however that a director held liable for personal bankruptcy may request that instead of being subject to the sanctions of personal bankruptcy or prohibition of management, he/she/it will instead incur personal liability for the shortfall of assets of the insolvent company that he/she/it manages[27].

(iii) the court has discretion over the duration of the personal bankruptcy or the prohibition on management, subject to a maximum of 15 years[28] and a maximum of 5 years for any prohibition on public functions, professions and office[29];

(iv) except in certain limited circumstances, there is no specific time period prior to the commencement of formal insolvency proceedings during which the wrongful action must have occurred. In practice the period is limited by the “informal” requirement that there be a link between the act in question and the insolvency of the company. In respect of (vii) and (viii) above, by definition the wrongful act must have taken place after the date of cessation of payments which, as explained above, depends upon a finding of fact by the court. This date cannot be more than 18 months prior to the date of the court order opening formal insolvency proceedings.

Other than the general defence of absence of one or more of the specific requirements for the offence, there are no specific defences to this action. A person may have some or all of the prohibitions lifted if he/she can show that they have made a sufficient contribution to the payment of the insolvent company’s debts.

2.4.3 The following persons may also be subject to personal bankruptcy:

(i) any director who has been found liable for having contributed to the shortfall of assets[30];

(ii) any director who has been found guilty of criminal bankruptcy.

In both cases, personal bankruptcy or prohibition on management is a complementary penalty decided upon by the criminal court and, can be either permanent or temporary and, if temporary, must not exceed five years[31].

2.5 Criminal bankruptcy (Banqueroute)

2.5.1 An individual *de jure* or *de facto* director may be subject to criminal bankruptcy in any of the following cases during the course of judicial reorganisation or judicial liquidation[32] opened against the company[33]:

(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 below market price or has used other inappropriate means to obtain funds;

(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.

It should be noted that there is no offence of attempted criminal bankruptcy.

2.5.2 If any of (i) to (v) are satisfied and the company is in a state of cessation of payments:

(i) it is for the court to decide if the directors are personally liable and guilty of the offence of criminal bankruptcy;

(ii) a person guilty of this offence is liable to imprisonment (maximum of five years or seven years for a company providing investment services) or a fine (maximum of 75,000 euro, or 100,000 euro for a company providing investment services) or both.

In addition, the court can impose any of the following:

(a) deprivation of civic, civil and family rights;

(b) prohibition (for a maximum period of five years) on having a public function or conducting a professional activity in the same field as that in which the offence was committed;

[27] Article L 653-11 of the French Commercial Code
[28] Commercial chamber of the Cour de cassation, 15 February 2000 n°97-16770.
[29] Article L. 653-10 of the French Commercial Code.
[30] Article L. 653-6 of the French Commercial Code.
[31] Commercial chamber of the Cour de cassation 22 March 2011 n°10-14889; of the Cour de cassation 22 May 2012 n°11-14366.
[32] Article L. 654-2 of the French Commercial Code.
[33] Ibid.

(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 five 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;

(g) furthermore, if there is a civil party to the criminal proceedings, the court may award damages to the civil party if it is the victim of the offending behaviour – typically the company – on the basis of the principles of tort (Articles 1382 et seq. of the French Civil Code).

(iii) The gravity of the offence will be reflected in the length of imprisonment or the amount of the fine ordered and in the nature and extent of any of the other sanctions 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 misappropriation or concealment of the company's assets (for which the acts in question must have been committed while the company was in a state of cessation of payments), there is no specific time period prior to the commencement of formal insolvency proceedings during which the acts concerned 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 director or associated person can be held liable for this offence if[34]:

(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 state of cessation of payments.

(iii) Absence of intent to defraud is a defence.

QUESTION 3

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.

(b) 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 French insolvency law provides expressly that liability that may attach to a formally appointed director of a company, also known as a *de jure* director, extends to " *de facto*" directors – known in French as *"dirigeants de fait"*. The definition of *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 they have caused.

***3.2 De facto* directors (dirigeants de fait)**

3.2.1 Before going into any detail, it is important to note that being qualified as a *de facto* director does not make such individual or legal entity liable *per se*.

[34] Criminal chamber of the Cour de cassation, 22 November 2011, no 10-81.562.

3.2.2 French legislation offers no definition of a *de facto* director. In absence of such a definition, French case law fills the gaps. According to the Court of Appeal of Paris[35], a *de facto* director is an individual who, or legal entity which, is not a *de jure* director but assumes similar functions and has similar powers in the management of the company that he/she/it exercises independently and has an influence on the decisions made within the company.

Hence, whether an individual or a legal entity is a *de facto* director is a question of fact for the French lower courts to determine, subject to the control of the Cour de cassation[36].

3.2.3 In establishing the question of fact based on a body of corroborating evidence, the two criteria below are the most significant:

(i) the management or administrative acts of the *de facto* director have been carried out without restriction and independently, so that the director had autonomous decision-making power. This implies that the *de facto* management situation is inconsistent with a position of subordination, such as it results from an employment contract (for example, if the claimed *de facto* director is given orders by another person to whom he is subordinated, such other person is the real *de facto* director)[37];

(ii) an active and positive decision-making role, implying that the *de facto* director has directly intervened in the management of the company, behaved as the master of the business and "unofficially" ran the company. There is no need to find that the person was treated as a director by the other directors. The key is the active involvement by the person in the determinative management of the company[38].

3.2.4 Examples of other corroborating evidence that may be taken into account by the French courts are the nature of the technical functions granted to the alleged *de facto* director (for example, commercial management, supply management), the powers granted to the *de facto* director (for example, placing orders with suppliers, signing cheques, hiring or dismissing employees) and the *de facto* director's behaviour (for example, the fact that he/she/it considers that the company belongs to him/her/it, that he/she/it behaves as a director of the company).

3.2.5 Based on such evidence, shareholders of the company are often targeted by liquidators as *de facto* directors to compensate for the shortfall of assets.

Shareholders who are regularly involved in the daily management of a company, which later files for insolvency, may be considered *de facto* directors. Having a majority shareholding will not in itself be regarded as evidence of intervention in the management of a company. It is for the French lower courts to determine whether or not a shareholder is a *de facto* director. The following are examples of where shareholders have been held to be *de facto* directors:

– the Paris Court of Appeal concluded that multiple factors such as attending a number of board meetings without being a board member, signing letters as a director without having the appropriate status and authority to do so and granting oneself the benefit of a company car meant that a shareholder with 38% of the share capital was considered a *de facto* director[39];

– the Paris Court of Appeal, in a different matter, ruled that a parent company was a *de facto* director of its subsidiary, not on the basis of the two criteria mentioned above, but on the basis that the business unit that the parent company transferred to its subsidiary continued to be operated by the parent company[40] as if it had remained within the parent company's scope of activities. In doing so, the court took into account the common operating mechanisms which often exist within group companies (such as paying for raw materials and packaging for products, making personnel available to the subsidiary as well as administrative accounting services). One may therefore conclude that the court held that what the parent company did went beyond just providing administrative and technical support in respect to the transferred business unit to determining the distribution strategy of the trademarked products of the transferred business unit, requesting the sale at a fixed price for each unit sold and invoicing for products in its own name without indicating that the sales were carried out in the name of its subsidiary.

3.2.6 Shareholders holding external roles with a company have also, albeit rarely, been considered *de facto* directors. Two examples are as follows:

– statutory auditors: the French courts have held that a founding partner of a company who also acted as the statutory auditor for that company was a *de facto* director as he did not act solely as the auditor of the company, but took important decisions, in particular, concerning the company's financing and the attempt to wind-up the company when he acknowledged that the company was in debt by as much as three thirds of its capital[41];

– lawyers: it has been held by the French courts that a lawyer who was also the majority shareholder of a company could be considered a *de facto* director where he held a decisive role in the management of the company, especially where: he fixed the price for the purchase of the business as a going concern; the registered office was located at his domicile whilst the activity of the company was located elsewhere; he decided on the financial and economical functioning of the company; and the *de jure* director was actually in a position of subordination[42].

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35 Court of Appeal of Paris, 16 December 1997, JCP E 1998, 718 p 250.
36 Commercial chamber of the Cour de cassation, 16 March 1999, n° 95-17.420.
37 Commercial chamber of the Cour de cassation 12 July. 2005, n° 02-19.860.
38 Commercial chamber of the Cour de cassation 30 May 2006, n° 05-14.958. Commercial chamber of the Cour de cassation, 27 June 2006, n° 04-15.831.
39 Court of Appeal of Paris, 11 October 1996.
40 Commercial chamber of the Cour de cassation 23 November 1999 n°1860 : RJDA 3/00 n°270.
41 Criminal chamber of the Cour de cassation June 27, 1983 n° 81-94465.
42 Commercial chamber of the Cour de cassation 15 February 2011 n°10-11.781.

3.2.7 Other individuals or legal entities that may be considered by the French courts as *de facto* directors include:

- banks: the Cour de cassation held on 30 October 2007 that the exercise by a banking institution of its obligation to advise its clients (see below) on the use of loaned funds may not be considered in itself as *de facto* management of the borrower company. However, a situation where the bank takes over the control of the company in financial difficulties by artificially maintaining credits in the current account and covering all its expenses where the *de jure* director could not hold the company's cheque books could amount to *de facto* management[43];

- franchisers: a franchiser who interfered in the management of its franchisee by giving orders to the franchisee, firing one of its employees and by deciding the working conditions of the franchisee's employees[44];

- suppliers/clients: a supplier has been held to be *de facto* director due to its intrusion in the management of its client. In one instance, this interference was characterised by the fact that the supplier sold the client's registered office, put the client's shop in his building and the client was obliged to pay his supplier in priority[45];

- family: the brother of the *de jure* director of a company, who negotiated and signed the quote for the company and the commitment it represented, negotiated payment terms with customers depending on the precise progress of the work and the release of funds to customers and who negotiated payment terms with the supplier and had free access to the cheque books of the company which he could sign to pay suppliers[46].

3.3 Third party liability during formal insolvency proceedings

3.3.1 Third parties who are involved with a company that 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 the wrongful action of those third parties. The existence of a fault (tort), damage and a causal link between the fault and the damage must be established by the claimant (for example, the company or the creditors) seeking recovery[47].

3.3.2 Financial and Banking Institutions

3.3.2.1 Duty to inform

Articles 111-2 of the French Consumption Code and 1134 of the French Civil Code impose a duty on financial and banking institutions to provide certain information to their clients. For these purposes, three different types of information exist: (i) advice, (ii) information construed as orders and (iii) information given as a warning. Advice may be given to clients under French law, but information that is interpreted as a request or order may not be given by banks to clients. As for the third type of information, the duty of "mise en garde" (cautionary duty), a banker is required to ensure that the client is aware of all the risks that may be incurred carrying out the operation in question.

The banker must choose the best way to advise the client, bearing in mind the knowledge of the client[48].

3.3.2.2 Wrongful termination of credit facility

Article L. 313-12 et seq. of the French Financial and Monetary Code governs the right of banks to terminate their credit facilities.

This Article provides that a bank may only reduce or terminate an open-ended facility on expiry of the written notice period provided in the facility. The notice period may not be less than sixty (60) days.

If the bank wrongfully terminates the credit facility in breach of this Article, the bank may be found liable for breach of contract and liable in tort to third parties, including the creditors of the company in insolvency proceedings acting through the *mandataire* judiciaire procedure.

The bank's liability under this head of challenge may be the full amount of damages suffered by the creditors if it is proved that the wrongful termination of the credit facility was the sole cause of the company being in insolvency proceedings[49].

That said, the second paragraph of Article L. 313-12 of the French Financial and Monetary Code provides for two exceptions where the bank may immediately and unilaterally terminate or reduce a credit facility granted to a company (in other words without any notice period.) These are as follows:

- where there has been seriously reprehensible conduct on the part of the company including: where the company is found guilty of an offence, where the company intentionally tried to or did mislead the bank as to its real financial situation and where there has been a serious breach of contract (such as refusing to give promised guarantees and to hand over the documents requested by the bank[50]); and

- where the company's situation has been irreparably compromised. It appears through case law that this does not mean where a company finds itself in a state of cessation of payments but where the company cannot restructure itself (for example where the company can no longer pay the premiums provided for in its restructuring plan, is only receiving a very limited amount of orders and/or is doomed to go into liquidation and be dissolved)[51].

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[43] Commercial chamber of the Cour de cassation, 23 September 2010, n° 09-83.274.
[44] CA Rouen 23 May 1978 :JCP 1979 II n°19235 note Notté.
[45] Commercial chamber of the Cour de cassation 4 April 1962, Rauscher c/ Ferrari : Bull. civ. III n° 215.
[46] Commercial chamber of the Cour de cassation 17 September 2002 n°1427 : RJDA 12/02 n°1307.
[47] Criminal chamber of the Cour de cassation, 11 oct. 1993, n° 92-81.260.
[48] Commercial chamber of the Cour de cassation, 4 June 1991 : RD bancaire et bourse 1992, n° 32, p. 151, obs. F.-J. Crédot et Y. Gérard. – Commercial chamber of the *Cour de cassation*, 22 May 2001, n° 98-14.741.
[49] Commercial chamber of the Cour de cassation, 23 October 2001, n° 98-18.788.
[50] Commercial chamber of the Cour de cassation, 2 June 1992, n° 90-18.313.
[51] Commercial chamber of the Cour de cassation. 21 November 2006, n°05-18.979.

3.3.2.3 Wrongful credit transactions (*octroi et soutien abusif de crédit*)[52]

Pursuant to Article L.650-1 of the French Commercial Code, when a company is in insolvency proceedings, including safeguard, reorganisation or liquidation, creditors may not be held liable for credit facilities granted to the company except in the case of:

- fraud: an event of fraud implies a criminal offence in the granting of the credit facility such as. extravagant financial operations (cavalerie financière). Fraud can also be characterised if the credit facility is given to the company for a purpose other than to start-up or maintain the business. A credit facility granted with the negligence of the banker will not be considered a fraudulent credit facility such as when the bank omits to request the provision of the company's accounts or to obtain the opinion of experts before granting the credit facility[53];
- interference in the company's management: this event relates to the event of *de facto* management; however, the influence of the bank on the management of the company needs to be "characterised", meaning that if the bank did not interfere, the company would not have made such or such decision. French academics believe that the wrongful (abusive) grant of a credit facility may be "characterised" where the bank is party to an oversight board or to a LBO where the bank grants the credit facility on the condition that the ratios are not violated. The Cour de cassation does not consider there to be interference in the company's management when, in accordance with a facility agreement, the bank reviews transfers which may not be carried out without being evidenced by invoice[54]; or
- if the guarantees given are disproportionate to the credit facility for which they were granted: most French academics believe that this example of a wrongful grant of credit facility is intended to target the practice of unusual requests for guarantees within the banking sector. For example, in order to obtain a facility to finance the purchase of freehold, banks normally require a mortgage over all the freehold even though the facility only finances part of the purchase of the freehold. Some academics believe that this rule against the wrongful granting of credit facilities is actually intended to deter banks from proceeding with what is called a "coup de râteau", meaning obtaining an excessive number of guarantees so as to have an unfair advantageous position relative to other creditors in the event of the borrower company entering into insolvency proceedings. The courts will determine whether the guarantees were disproportionate or not on the date the guarantee was given by reference to the maximum amount owing by the company to the bank, including interest, fees and accessory amounts.

If the court holds that one or more of the above events exists, the court must then determine whether there is a causal link between the wrongful granting of the credit facility and the prejudice caused to the borrowing company, other creditors or even other third parties such as guarantors.

According to the majority of French academics, this Article implements a presumption that creditors that grant credit facilities (that is, mostly banking institutions) are not liable for the facilities granted except where the credit facility is considered abusive (wrongful) in one of the three circumstances outlined above. This would mean that even if the bank committed a fault in respect to the credit facility granted, the bank would be immune from tortious liability unless, the facility was considered abusive under either fraud, 'characterised' interference in the management of the company or disproportionate guarantees. This, however, is not the view of the French Constitutional Council that considers that banking institutions are not immune from liability as this Article of the French Commercial Code specifically provides for the three cases where banking institutions may be held liable[55].

3.3.3 Auditors Pursuant to Article L. 822-17 of the French Commercial Code: *"Auditors are responsible, in respect of a person or entity or third parties, for the consequences of errors and omissions committed by them in the exercise of their functions. Responsibility may not be sought for any information or disclosures of fact on which they proceed in the execution of their mission. They are not civilly liable for offences committed by directors and officers unless, having knowledge, the offences are not indicated in their report to the General Assembly or the competent authority referred to in Article L. 823-1".*

French courts will hold statutory auditors liable if they have committed a fault which has caused damage. This means that a creditor will have to prove that there was a damage and also a casual link between the fault and the damage. A claimant has three years in which to commence a claim pursuant to Article L. 225-254 of the French Commercial Code. The three year period starts on the date of certification of the company's accounts except if the statutory auditors concealed the fault, in which case, the three year period commences on the date when the damage is suffered[56].

The three year limitation period is applicable to insolvency proceedings[57]. For example, a statutory auditor was held liable when he certified accounts of the company without undertaking any serious inspection[58]. However, he cannot be held liable for a shortfall of assets resulting from his failure to inform the relevant parties of the problems discovered upon completion of the company's accounts.

3.3.4 The end of the insolvency proceedings does not bar a creditor from claiming against third parties if the claim can be formed outside of its rights against the debtor.

For example, it was found that the initiation of proceedings against the licensor did not interrupt the proceedings in respect of the patent owner who had conceded the operation[59].

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[52] Law applicable to insolvency proceedings opened after 1st January 2006.
[53] Commercial Tribunal of Nanterre, 7th chamber, 19 June 2009, RG n° 2008F00426.
[54] Commercial chamber of the Cour de cassation, 30 October 2007, n°06-12.677.
[55] Constitutional Council 22 July 2005 n° 2005-522.
[56] Commercial chamber of the Cour de cassation, 15 September. 2009, no 08-18.876, Commercial chamber of the Cour de cassation., 1st July. 2008, no 07-17.729.
[57] Commercial chamber of the Cour de cassation,13 February 2007, no 03-13.577.
[58] Commercial chamber of the Cour de cassation, 18 May 2010, no 09-14.281.
[59] Commercial chamber of the Cour de cassation, 11 March 2008, n° 06-19.616

3.3.5 Furthermore, creditors have a direct right to claim (action directe) against the insurers of the company[60] or against third parties even if the proceedings are closed[61]. Guarantors of the debtor are included within the pool of third parties against whom creditors have a direct right of claim.

However, pursuant to Articles L. 622-28 (safeguard proceedings), L. 631-14 (reorganisation proceedings) and L. 641-3 (liquidation proceedings) of the French Commercial Code, claims against guarantors who guarantee a security *(caution)*, are co-debtors, autonomous guarantors or have granted a personal security are suspended as from the date of the court decision opening the insolvency proceedings up until the adoption of a business restructuring plan or the judicial winding-up of the company.

3.3.6 The loss may be general – suffered by all of the creditors – in which case only the representative of the creditors can bring the claim. Alternatively, the loss may be specific to one creditor in which case the claim can only be brought by the injured creditor. In order to be allowed to bring such a specific claim, 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/her/it. These claims are of a civil nature for which damages may be awarded (either to the company in the event of a general claim or to the injured creditor in the event of an individual claim).

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 Like many other legal systems, out of a concern to protect creditors and the company itself, French law recognises the right to bring proceedings to render void certain payments and transactions made during the *suspect period* (which, as explained in Question 1, begins with the date on which the company finds itself in a state of cessation of payments and ends on the date of the order commencing formal insolvency proceedings). The basis of such concern is the risk that the company facing financial difficulties may, because of the unequal bargaining power that exists on account 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 counterparty and thus are detrimental to the overall body of creditors.

4.1.2 Actions to avoid *(actions en nullité)* payments or transactions *(actions en nullité)*[62] are intended to reconstitute the assets of the company by either imposing a sanction on the company or reversing the inequality created as between creditors. A third party contracting with the company may therefore see transactions that it entered into with the company during the suspect period held void.

4.1.3 An action to avoid based on Articles L. 632-1 and L. 632-2 of the French Commercial Code may not be brought by a creditor since Article L. 632-4 of the French Commercial Code provides that it may only be brought by the administrator, the *mandataire judiciaire*, the person appointed by the court to execute the plan or the public prosecutor (acting jointly or individually).

4.1.4 In addition to the statutory basis for an action to avoid, French civil law also recognises a claim, known as the *"action paulienne"* (a right of claim, which Article 1167 of the French Civil Code provides to the creditors of a debtor, to challenge transactions or other acts undertaken by the debtor defrauding creditors' rights). Such a right of claim is not linked to the suspect period and can be used by creditors who do not have the right to bring an action to avoid.

4.2 Summary of heads of challenge

4.2.1 The transaction or payment must have occurred during the suspect period (that is, after the date of cessation of payments and prior to the judgment opening formal insolvency proceedings). It must have been undertaken by the company and not by a third party. It must fall within one of the eleven heads of challenge enumerated in Article L.632-1 of the French Commercial Code (applicable during judicial reorganisation and judicial liquidation under Article L. 641-14 of the French Commercial Code). It is not, however, necessary for the person bringing the action to evidence that the act has caused loss to the company. The heads of challenge fall into two different categories: (a) those which must be held automatically void by the court if the legal requirements are met; and (b) those which, if the legal requirements are met, may be held void by the court at its discretion.

4.2.2 The potential heads of challenge are the following:

(a) Transactions which are automatically held null and void:

(i) any transaction under which the ownership of a fixture, any real estate or a chattel is transferred for no consideration (transactions for no consideration);

[60] Mixte Chamber of the Cour de cassation, 15 June 1979 : D. 1979, jurispr. p. 561, note F. Derrida et A. Honorat; JCP G 1979, II, 19197, note A. Besson et J. Bigot.

[61] Commercial chamber of the Cour de cassation, 17 December 2003, n° 02-12.891Commercial chamber of the Cour de cassation, 4 oct. 2005 : JurisData n° 2005-030100; Act. proc. coll. 2005, comm. 240.

[62] Commercial chamber of the Cour de cassation, 21 February 2012, n° 11-13.513.

(ii) any "commutative" transaction in which the company's obligations far exceed those of its counterparty (an unequal transaction);

(iii) any payment of debts made by any means whatsoever which are not due as at the date of payment (payment of debts not due);

(iv) any payment of debts which are due, but made in a manner not commonly admitted in business relationships;

(v) all deposits and "consignments" of sums of money given, pursuant to a court order, as guarantees during the suspect period, unless given as a result of a final and binding court decision which was issued prior to the opening of bankruptcy proceedings;

(vi) security granted over the debtor's assets for existing debts;

(vii) all "conservatory measures", unless the filing or the act of seizure pre-dates the date of cessation of payments;

(viii) any authorisation, exercise or resale of options defined in Articles L. 225-17 et seq. of the French Commercial Code (that is, "stock-options");

(ix) any transfer of assets or rights into a "fiducie" (a sort of French statutory quasi-trust) unless the transfer took place as a guarantee of a debt that was entered into at the same time;

(x) any amendment to a fiducie contract affecting rights or assets already transferred into a *fiducie* as a guarantee of debts entered into prior to the amendment;

(xi) where the debtor is an individual businessman with limited liability (*entrepreneur individuel à responsabilité limitée*), any allocation or modification in the allocation of an asset (save for the payment of revenues mentioned under Article L. 526-18) which results in a decrease in the assets of the estate of the insolvent business for the benefit of the businessman's personal assets.

(b) Transactions which may be avoided at the court's discretion:

(i) transactions mentioned in (a)(i) may be avoided where they were entered into during the six-month period prior to the date of cessation of payments[63]. As stated above, however, such transactions must be avoided if made during the suspect period;

(ii) any transaction for consideration entered into and any payment made for debts that have fallen due during the suspect period if the counterparty knew that the company was in a state of cessation of payments. In addition, any notice to a third-party holder, seizure or objection may also be avoided where it has been delivered or undertaken by a creditor with knowledge of the state of cessation of payments[64].

Each head of challenge is considered briefly below.

4.3 Transactions for no consideration

4.3.1 The statutory text defines such transactions as *"les actes à titre gratuit translatifs de propriété mobilière ou immobilière"* (transactions under which ownership to fixtures, or any real estate, or chattels is transferred for no consideration). This type of transaction is automatically void if entered into during the suspect period, but the court may also decide that such transactions are void if entered into during the period of six months prior to the date of cessation of payments.

4.3.2 Included in this type of transaction are:

(a) relief from debt: granting relief from debts will be treated as reducing the assets of the insolvent company. Granting relief from debts, including relief from debts forming part of another transaction, will be voidable if granted for no consideration. If the relief is granted in respect of a debt included in another transaction, it may be hard to demonstrate that it was given without consideration; alternatively, the transaction may be void under a different head of challenge, for example, if its terms strike a poor balance between the parties;

(b) gifts: regardless of whether the purchaser acted in good faith, or whether the transaction was notarised, in the case of a gift given in person (or by any other means), the gift (and even the on-sale of the gift) during the suspect period will be held void unless the gift was given for consideration. To determine whether the gift was made during the suspect period, the date that will generally be taken into account is the date the gift was accepted;

(c) "disguised gifts": a number of transactions may be considered as disguised gifts, which will be held as void if concluded during the suspect period. An example of a 'disguised gift' is the transfer of shares in consideration of a loan where the lender has no intention of requesting repayment of the loan[65].

4.4 Unequal transactions

4.4.1 The statutory text defines such transactions as *"tout contrat commutatif dans lequel les obligations du débiteur excèdent notablement celles de l'autre partie"* (any bilateral "commutative" transaction in which the debtor's obligations clearly exceed those of the counterparty). 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 goods, the creation of a guarantee, and the transfer of a trademark.

[63] Article L. 632-1 of the French Commercial Code.
[64] Article L. 632-2 of the French Commercial Code.
[65] Civil chamber of the *Cour de cassation*, 2 March 2004, n° 01-13.767.

4.4.2 The advantages drawn from the contract by each of the parties must be clearly unequal as at the date of the transaction (taking into account all assets and debts forming part of the transaction i.e. not only the price) and to the detriment of the company. The difference must (a) be objectively ascertained and ascertainable and (b) be economically and mathematically clear. There must be no room for the parties to obtain a more or less advantageous position.

4.4.3 An example of an unbalanced/unequal transaction is where the obligations of the purchaser of a business are unbalanced as compared with the obligations of the seller such as where the business is only composed of a few assets and the purchaser is being obliged to proceed with the redundancy of employees dedicated to the business[66].

4.5 Payment of debts which have not yet 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 carried out, of debts which are not due at the date of payment).

As any payment made which is not due will be void regardless of how the payment was made, a payment made during the suspect period may be held void even if made by transfer, novation or contractual compensation of debts.

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 of debts that have fallen due made in a manner other than in cash, commercial instruments, wire transfer, deposit slip of transfer in accordance with Law 81-1 dated 2 January 1981 facilitating credit to business (codified under Article L. 313-23 et seq. of the French Monetary and Financial Code), or by any other method of payment commonly recognised in business relations).

4.6.2 The purpose is to avoid payments that, on account of their unusual nature, grant an advantage to one creditor. The notion of payments commonly recognised in business relations covers any method of payment which is generally and habitually used in the appropriate field of business affairs.

4.6.3 The burden is on the defendant to bring sufficient evidence that the payment is commonly recognised in business relations. An example of a payment that was considered uncommon in business affairs, and therefore void, was the payment of the cost of works by the resale of parking spaces in the building[67].

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 2350 du Code Civil, à défaut d'une décision de justice ayant acquis force de chose jugée"* (any deposit or consignment of monies pursuant to Article 2350 of the French Civil Code unless made pursuant to a final and binding court ruling). Article 2350 of the French Civil Code relates to any deposit or consignment of money, commercial instruments, or securities which an entity has been ordered to make as a guarantee (or as a conservatory measure). The deposit or the consignment will not be avoided if it was ordered by a final and binding court decision.

4.7.2 The purpose is to avoid the priority right that such deposit or consignment grants to the creditor in question in accordance with Article 2333 of the French Civil Code.

4.8 Creation of security 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 antérieurement contractées"* (any mortgage whether contractual, judicially-ordered or pursuant to law as between spouses, and any pledge over assets of the debtor granted for debts previously incurred). The text covers 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 debt was incurred before the grant of security and if the security has been granted during the suspect period, the action to avoid must succeed.

However, it has been held by the French courts that this text is not applicable to a mortgage granted to a creditor in consideration of a guarantee granted simultaneously by the debtor even if the mortgage was granted in respect of a credit facility which had already been drawdown. The courts have held that this text is not applicable as the guarantee, granted simultaneously with the grant of the mortgage, is not a debt incurred prior to the granting of the security[68].

4.8.2 Again, the reasoning behind the existence of 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. The existence of an advantage to the creditor in question, through the grant of additional or new security, is presumed.

4.9 Conservatory measures

4.9.1 The statutory text provides for the avoidance of: *"toute mesure conservatoire, à moins que l'inscription ou l'acte de saisie ne soit antérieur à la date de cessation des 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 Where the recovery of a creditor's claim appears threatened, the court may make an order to seize the debtor's assets or to grant judicial security over the debtor's assets (a 'conservatory measure'). Assets seized or judicial security enforced after the date of cessation of payments are void.

[66] Commercial chamber of the *Cour de cassation,* 27 June 2006, n°04-19.423.
[67] Commercial chamber of the *Cour de cassation* 13 May 2007, n°06-15.619.
[68] Commercial chamber of the Cour de cassation 10 December 2002, n° 99-19.300.

As a general rule, judicial security can only be enforced once it has been publicised – a two stage filing process. Judicial securities granted over the assets of a debtor become enforceable on the date all publicity measures have been fulfilled in accordance with Articles L. 532-1 and L. 533-1 of the French Enforcement of Civil Procedures Code. Publication of such judicial measures is undertaken in two steps: (i) a temporary filing and (ii) a definitive (final) filing; publication is not effective until the definitive filing. Once the definitive filing has been carried out, the effective date is backdated to the date of the temporary filing. Therefore, a judicial security will only be held void if the two steps have been carried out but only when the temporary filing took place during the suspect period.

As an exception to the above, should the court authorise a pledge over the shares or securities held by the debtor, this pledge is not subject to filing but only to notification to the entity in question. In this case, French academics appear to agree that such conservatory measure is considered void if the notification takes place during the suspect period.

The purpose of this action to avoid is to protect the company against conservatory measures obtained by a creditor which would have the effect of giving that creditor an advantage. The reasoning behind this head of challenge is similar to that for security granted for existing debts.

4.10 Transactions on stock-options

4.10.1 Stock-options granted by the company or exercised by an employee during the suspect period are held void.

4.10.2 The purpose of this provision is to prevent directors from using their insider knowledge of the company's financial difficulties to dispose of stock just before the opening of formal insolvency proceedings.

4.11 Transfers to a *fiducie*

4.11.1 The French version of a quasi-trust, *fiducie*, has only existed since 2007. The statutory text defines the head of challenge as *"tout transfert de biens ou de droits dans un patrimoine fiduciaire à moins que ce transfert ne soit intervenu à titre de garantie d'une dette concommittante"* (any transfer of assets or rights to a fiducie unless the transfer was given as a guarantee of a debt simultaneously incurred).

4.11.2 The purpose is to protect creditors against the company transferring assets or rights into a fiducie, which would shelter the assets or rights in the event of insolvency.

4.11.3 Any amendment to a contract of fiducie which would affect rights or goods already transferred to a fiducie as guarantee of debts incurred prior to the amendment will also be held void if made during the suspect period.

4.12 Allocations (or modifications to allocations) of rights and assets by an individual entrepreneur

This head of challenge is fairly recent and renders void the allocation (or modification of an allocation) of assets during the suspect period to the detriment of creditors (i.e. reducing the assets of the insolvent business for the benefit of another business, or the owner of the business).

This avoidance provision may apply, not just to assets, but also to the allocation of liabilities to the insolvent business, although the latter would also be an act of mismanagement for which the individual entrepreneur could be held personally liable (see Question 2).

4.13 Counterparty aware that the company was in a state of cessation of payments

4.13.1 Under this head of challenge a court may, at its discretion, render void certain payments and transactions entered into during the suspect period. In other words, these transactions may be avoided by the court but are not automatically null and void. The statutory text[69] provides: *"les paiements pour dettes échues effectués à compter de la date de cessation des paiements et les actes à titre onéreux accomplis à compter de 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 on or after the date of cessation of payments and transactions for consideration entered into on or after the date of cession of payments may be held void if those dealing with the debtor were aware of the cessation of payments).

4.13.2 The transaction or payment must have taken place during the suspect period. There is no need to show that the company suffered a loss as a result of the transaction. The key element is the counterparty's knowledge that it was dealing with a company that was in a state of cessation of payments; it is not enough that the counterparty knew that the company was in financial difficulties. In practice, it will be easier to prove that certain creditors (such as a company's bankers, lawyers, accountants, statutory auditors, etc.) had knowledge of the date of cessation of payments as their appointment grants them greater knowledge of the functioning and the financial situation of the insolvent company.

4.14 *"Action Paulienne"*

Unlike an action to avoid, creditors, the *mandataire judiciaire*, the person appointed by the court to execute the plan and the *contrôleurs* may all bring a claim, known as the "*action paulienne*", pursuant to Article 1167 of the French Civil Code if any transaction or act was carried out by the debtor with the intention of defrauding creditors. The claim will be available regardless of whether the company is in a state of cessation of payments and therefore can be made in respect of any transaction or act of the debtor, whether entered into during the suspect period or not. Fraudulent intent must be shown to have existed on the part of the debtor – such fraudulent intent aimed at harming the creditor. If such fraudulent intent can be shown to exist and if the creditor can show that it has a valid and existing debt against the company that has been declared, the creditor can request that the transaction be held unenforceable against that creditor.

[69] Articles L. 632-2 and L. 641-14 of the French Commercial Code.

An *action paulienne* can only lead to the fraudulent act or transaction being held unenforceable against the creditor; it does not render the act or transaction void. Accordingly, the transaction or act carried out by the debtor remains valid and binding between the debtor and third parties (other than the party to the *action paulienne*) including co-contracting parties to the transaction in question[70].

In the event the *action paulienne* is brought in respect of a transaction between the debtor and co-contracting parties, this will give rise to a conflict between protecting the interest of the creditor against the fraudulent transaction and protecting the co-contracting parties for whom the transaction remains binding.

French courts have resolved this issue by determining whether the co-contracting parties were the accomplices of the debtor in the fraudulent transaction or whether they entered into the transaction in good faith.

Here, French case law observes a distinction between gratuitous transactions and transactions for consideration. If the fraudulent transaction was a gift, the co-contracting party will be deemed to be an accomplice of the debtor, without the creditor having to satisfy any burden of proof[71]. But if the fraudulent transaction was for consideration, the creditor will be required to prove bad faith on the part of the co-contracting party[72]. The court will not sanction an *action paulienne* if the creditor has not satisfied this burden of proof.

If the court holds that the co-contracting party was an accomplice to the debtor as regards the fraudulent transaction, the *action paulienne* will deprive the co-contracting party of the benefit of the fraudulent act (so as to protect the defrauded creditor). In this event, the third party co-contractor will be entitled to a warranty claim against the debtor but in practice such claims are rarely used when the debtor is insolvent or in financial difficulties.

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 French Commercial Code.

5.1.2 Civil liability claims for the shortfall of assets and personal bankruptcy can only be brought by the liquidator, the public prosecutor or by the majority of the *contrôleurs* (appointed by the court from among the creditors to help the *mandataire judiciaire*) in the event the liquidator fails to bring such a claim after formal notice to do so[73]. These civil claims are brought before the commercial court (*Tribunal de Commerce*) or the civil court (*Tribunal de grande instance*) depending upon which has jurisdiction over the insolvency proceedings in respect of the company[74]. Should the debtor be a company which carried on a commercial activity, the commercial court has jurisdiction and in all other cases, it is that of the civil court.

5.1.3 Criminal claims based on criminal bankruptcy (*banqueroute*) or on the fraudulent ‘organisation’ of bankruptcy may only be brought by the public prosecutor. However, other persons may initiate the criminal claim if the public prosecutor decides to not bring a criminal claim by forming a civil party[75] which will seize the relevant Juge d’Instruction who will then proceed with criminal investigations[76]. In the case of criminal bankruptcy, only the liquidator, the administrator, the *mandataire judiciaire*, the employees’ representative and the person appointed by the court to execute the plan of reorganisation may form a civil party[77]. Furthermore, in the event the judicial representative fails to initiate such a claim, the majority of the court-appointed *contrôleurs* may initiate such a claim after formal notice from the judicial representative to do so. These criminal claims are brought before the criminal court (*tribunal correctionnel)*. Any creditor may also join the criminal proceedings as civil party if the criminal claim has already been brought and if he or she is able to establish an individual specific loss that is different from the amount of the creditor’s claim and results directly from the offence.

[70] Commercial chamber of the Cour de cassation, 14 May 1996, no 94-11.124.
[71] Commercial chamber of the Cour de cassation, 24 January 2006, n° 02-15.295.
[72] Commercial chamber of the Cour de cassation 20 February 2007, n° 05-18.241.
[73] Article L. 651-3 of the French Commercial Code.
[74] Article L. 621-2 of the French Commercial Code.
[75] Articles 1 and 2 of the French Criminal Procedure Code: criminal proceedings may be initiated by civil parties, meaning all those who have personally suffered damage directly caused by an offence, it being a felony, misdemeanour or a petty offence, in accordance with the provision of the French Criminal Code. May only form a civil party, those who have filed a prior complaint in front of the public prosecutor or the French police services (Article 85 of the French Criminal Procedure Code).
[76] Article 85 of the French Criminal Procedure Code.
[77] Article L. 654-17 of the French Commercial Code.

QUESTION 6

6. Remedies: orders available to the domestic court

In respect of the heads of challenge and liability of *de jure* or *de facto* directors identified in Questions 2, 3 and 4 above, what sanctions may be ordered against such directors by a French domestic court?

Heads of challenge	**Sanctions available**
Liability for shortfall of assets	Liability is civil. De jure and/or de facto directors may be ordered to compensate from their own pockets all or part of the shortfall of assets that their mismanagement contributed to. The court may also order professional sanctions (see below) for 'personal bankruptcy' in the event a director held liable for the shortfall of assets has not paid the compensation ordered in relation to that liability[78].
Personal bankruptcy	Liability is civil. If the court holds de facto and/or de jure directors liable for personal bankruptcy, they will be prohibited from managing, administrating and controlling any commercial business and any form of company which carries on an economic activity[79]. The court will also decide to order that they may not hold any elective public office for the same period as the prohibition but subject to a maximum period of five years[80]. As mentioned in Question 2, as an alternative to a personal bankruptcy ruling, the court may decide instead to solely order prohibition on a management[81] and may tailor such prohibition to cover certain types of activity only. The maximum period for which personal bankruptcy or prohibition of management may be ordered is 15 years[82]. It must be noted however that a director held liable for personal bankruptcy may request that instead of being subject to the sanctions of personal bankruptcy or prohibition of management, he/she/it will instead incur personal liability for the shortfall of assets of the insolvent company that he/she/it managed[83].
Heads of challenge	Sanctions available
Criminal bankruptcy	Liability is criminal. When de jure or de facto directors, who are individuals, are held liable, they may be sentenced up to a maximum term of five years imprisonment and/or a fine up to 75,000 euro (seven years and 100,000 euro for investment service providers[84]). If the de jure or de facto directors are corporate or other such legal entities, then (i) pursuant to Articles 131-38 of the French Criminal Code, they may incur a fine up to a maximum of five times the amount of the maximum fine for an individual which gives a maximum of 375,000 euros, and (ii) pursuant to Article 131-39 of the French Criminal Code, they may, amongst other sanctions, be dissolved, prohibited from carrying on the activity in the course of which the offence was committed for a maximum period of five years and being placed under judicial control[85]. In addition, should the de jure or de facto director held liable for criminal bankruptcy be an individual, his or her sentence may include any of the following orders[86]: − deprivation of civil rights; − prohibition for a maximum period of five years from 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 five years; − prohibition for a maximum period of five years from issuing certain forms of cheque; − that the judgment be published, and, at the court's discretion and unless the civil courts have already made such civil orders, incur civil liability for personal bankruptcy or prohibition of management, for which the possible sanctions are mentioned above[87]. If civil proceedings are associated with the criminal proceedings, the de jure or de facto director in question may be ordered to compensate the company for any loss that his offending conduct has caused.
Fraudulent organisation of insolvency	Pursuant to Article L. 654-9 of the French Commercial Code, the same sanctions for personal bankruptcy may be ordered in the event of fraudulent organisation of insolvency.

[78] Article L. 653-6 of the French Commercial Code.
[79] Article L. 653-2 of the French Commercial Code.
[80] Article L. 653-10 of the French Commercial Code.
[81] Article L. 653-8 of the French Commercial Code.
[82] Article L. 653-11 of the French Commercial Code.
[83] Article L. 653-11 of the French Commercial Code.
[84] Article L. 654-3 of the French Commercial Code.
[85] Article L. 654-7 of the French Commercial Code.
[86] Article L. 654-5 of the French Commercial Code.
[87] Article L. 654-6 of the French Commercial Code.

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 (for example, 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 Pursuant to Articles L. 631-4 and L. 640-4 of the French Commercial Code, the company, through its director(s), meaning:

the general director in a traditional *société anonyme* who may also have the role of president of the board (*Conseil d'administration*);

– the president of the management board (*directoire*) of a two-tier managed *société anonyme* with a supervisory board and a management board;

– the president, and as the case may be, the general directors of a *société par actions simplifiée*; and/or

– the director (*gérant*) of a *société à responsabilité limitée*,

must request the opening of judicial reorganisation or judicial liquidation proceedings by the court within 45 days of the date of cessation of payments (except where the company has requested the opening of *conciliation* proceedings). Pursuant to Article L. 653-8 of the French Commercial Code, if the director of the company in cessation of payments fails to make the request, he/she/it may be prohibited from exercising any management role (see Question 2).

Pursuant to Article L. 2323-44 of the French Employment Code, before filing for judicial reorganisation or judicial liquidation, the company, through its directors, must inform the workers' council and call and hold a meeting of the council. Article 2323-4 of the French Employment Code also provides that when consulting the workers' council, the council ought to have sufficient time to be able to form and give an opinion on, in this case, the opening of insolvency proceedings.

However, in practice the seriousness of the financial situation of the company normally leads to informing, and consulting with, the workers' council in a very short timeframe so that the company does not breach its obligation to open formal insolvency proceedings within 45 days of the cessation of payments.

Despite this timeframe to open insolvency proceedings, the company must comply with the legal timeframe to consult the workers' council otherwise the directors in place may be held guilty of a "délit d'entrave" which was the case when a director only consulted the workers' council one day before declaring the cessation of payments in its filing for insolvency proceedings[88].

This legal timeframe allows the representatives of the employment bodies of the company to either participate in the process of opening insolvency proceedings or to bring claims against the opening of such proceedings[89].

7.1.2 Thereafter, the request to open judicial reorganisation or judicial liquidation is made at the registry of the commercial court where the company is registered (save where the company has commenced court-supervised *conciliation* proceedings when the court supervising the *conciliation* proceedings is the appropriate court).

7.1.3 The request must be accompanied by a number of documents that the director will need to put together. These documents are listed under Articles R. 631-1 and R. 640-1 of the French Commercial Code. Examples of such documents include a Kbis extract (commercial extract) of the company from the relevant Trade and Company Registry and the annual accounts of the company for the last financial year.

7.1.4 It should be noted that insolvency proceedings, being judicial reorganisation or judicial liquidation proceedings, may also be commenced in a number of different ways by persons other than the director of the company (for instance, by one or more creditors of the company or by the public prosecutor), provided that the company is not under *conciliation* proceedings[90].

7.1.5 The director of a company which is not yet in a state of cessation of payments may file for the opening of safeguard proceedings (it is not obligatory as is the case when a company is in a state of cessation of payments). Safeguard proceedings may only be commenced by the company's director on a voluntary basis; they cannot be commenced by third parties as for judicial reorganisation and judicial liquidation. For more information on safeguard proceedings, see Appendix.

[88] Criminal chamber of the Cour de cassation. 15 October 1991, n°89-83.950.
[89] Commercial chamber of the Cour de cassation. 3 July 2012, n° 11-18.026.
[90] Articles L. 631-5 and L. 640-5 of the French Commercial Code.

7.2 Obligation to communicate information in the initial stages of the proceedings

7.2.1 Pursuant to Article L. 622-6 of the French Commercial Code (applicable to safeguard proceedings), also applicable to judicial reorganisation based on Article L. 631-14 of the French Commercial Code and to judicial liquidation based on Articles L. 641-1, L. 641-4 and L. 641-14 of the French Commercial Code, the company, through its director, must assist the administrator or liquidator in drawing up an inventory of the company's assets, liabilities and encumbrances. To this effect, a director is under an obligation to cover the following:

information on assets that the company holds that may be claimed by third parties: pursuant to Article R. 622-4 of the French Commercial Code; this must include encumbered assets as well as assets held on deposit, rented or under a leasing contract, or subject to a retention of title clause or that may otherwise be claimed by third parties;

a list of creditors: pursuant to Article R. 622-5 of the French Commercial Code, this list must be filed with the administrator and the *mandataire* judiciaire within eight days of the opening of the proceedings and must include 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 their due date, the nature of the debts and any guarantees or charges relating to them, and the object of the main on-going contracts;

- the amount of liabilities;
- the main on-going contracts; and
- information on pending proceedings.

Pursuant to Article L. 653-8 of the French Commercial Code, the director must provide these documents and this information to the administrator or liquidator within one month of the opening of judicial reorganisation or judicial liquidation, or risk a prohibition on management. However, for a director to be liable, he/she must be acting in bad faith and not merely being negligent. In order to evidence such bad faith, it is advisable for the administrator or liquidator to send a formal notice to the directors requiring them to provide such documentation.

7.2.2 Article L. 622-5 of the French Commercial Code also provides that as from the opening of the insolvency proceedings, any third party is obliged to provide the administrator, on his/her request, with any document relating to the company's accounts.

7.2.3 During safeguard proceedings, it is provided under Article L. 622-6-1 of the French Commercial Code that if no public officer is *mandat*ed to draw up an inventory, the company, through its director and employees, is to draw up the inventory which then has to be certified by the statutory auditors. If the company does not draw up the inventory within eight days from the opening of the safeguard proceedings or within the period determined by the court, the *juge-commissaire* will appoint a qualified professional (listed in the Article) to draw up the inventory.

7.3 Right to be heard during the proceedings

7.3.1 Throughout the insolvency proceedings, the company, through the directors, has a number of specific rights to be informed, intervene and put forward his/her/its observations either to the administrator, the liquidator, the juge commissaire or the court.

7.3.2 An example of being heard is Article L.623-3 of the French Commercial Code which provides that the company, through its directors, may be consulted by the administrator and must be at least informed by the administrator of the reorganisation measures the administrator will propose based on the information and offers received.

7.4 Obligation to collaborate during the proceedings

7.4.1 Given that the director of the company in question is often the person best placed to know and understand the company and its activities, such a persons collaboration with the judicial organs/officers conducting the insolvency proceedings will be invaluable. French law thus provides for the involvement of the director of the company at all stages of the proceedings.

7.4.2 Besides the collaboration of the director in the initial stages of the proceedings provided above, pursuant to Article L.623-1 of the French Commercial Code, under safeguard and judicial reorganisation proceedings (Article L.631-18. of the French Commercial Code), the company, through its directors, must assist the administrator appointed by the court in drawing up a report on the economic and social position of the company. The report must identify the origin, nature and significance of the difficulties affecting the company. The administrator must also propose in the report either a plan for the reorganisation of the company or its judicial liquidation.

7.4.3 Other examples where the company, through its directors, must collaborate with the organs/officers appointed by the court, during insolvency proceedings are the following:

at the request of the administrator, the directors 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.622-4 of the French Commercial Code);

as from the date of opening the proceedings, the company, through its directors, must inform the administrator of all the establishments of the company and assist in accessing such establishments, provide a list of employees as well as any information that may determine salaries and indemnities to be paid (Article R. 622-2 of the French Commercial Code);

on the order of the *juge-commissaire*, during liquidation proceedings, the liquidator may request the directors or any employee of the company that may have useful information to automatically forward their electronic mail from their professional email service to the email address designated by the liquidator (Article R. 641-40 of the French Commercial Code).

7.4.4 Should a director intentionally not fulfil his/her obligations to collaborate with the organs and officers appointed under the insolvency proceedings to which the company is subject and that non-cooperation interferes with or prevents the smooth conduct of the insolvency proceedings, he/she/it may be sanctioned and held liable for personal bankruptcy under Article L. 653-5, paragraph 5, of the French Commercial Code (see Question 2).

7.5 Rights granted to directors (applicable in both safeguard and judicial reorganisation proceedings)

7.5.1 The director of the company in question has the right (*locus standi*) to request the *juge-commissaire* to seize the court to replace the administrator or expert(s) appointed by the court during the safeguard proceedings (Article L.621-7 of the French Commercial Code). Naturally, any decision to use this right needs when using it, careful consideration since if the court refuses to change the administrator, co-operation between the director and the administrator may be jeopardised by the conflict.

7.5.2 At any time during the proceedings, the director 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 reorganisation or judicial liquidation of the company (Articles L. 622-10 and L 631-15 of the French Commercial Code).

7.5.3 A director has the power to challenge, on behalf of the company, any decision taken by judicial organs during the procedure that by law is open to challenge (for example, the decision of the *juge-commissaire* to admit, reject or contest debts of the company submitted by creditors in the course of the insolvency proceedings (Articles L.624-3 and L. 631-18 of the French Commercial Code)).

7.5.4 The director has the right (locus standi) to request that the court extends the observation period (Articles L.621-3 and L 631-15 of the French Commercial Code).

7.5.5 Throughout the observation period, the director has a right to be informed by the administrator of the progress of the administrator's objectives (see 7.6.4 below).

7.5.6 The *mandataire judiciaire* must seek the director's observations on proposals to admit, reject or contest before the competent court debts owed by the company and duly submitted by the creditors (Articles L.624-1 and L. 631-18 of the French Commercial Code).

7.5.7 The court must summon to appear before it the director of the company before it takes a decision to: (i) extend the observation period (Articles R.621-9 and Article R. 631-7 of the French Commercial Code), (ii) modify the objectives granted to the administrator (Articles R.622-1 and R. 631-17 of the French Commercial Code), (iii) order the judicial liquidation of the company following the commencement of an observation period or (iv) order a plan of reorganisation (Articles L.622-10 and L. 631-15 of the French Commercial Code).

7.5.8 Pursuant to Articles L. 621-4, L. 627-1 et seq., L. 631-9 and L.631-21 of the French Commercial Code, during either safeguard or judicial reorganisation proceedings where an administrator has not been appointed, the director is to exercise all the powers that are normally granted to the administrator so that, generally speaking, the directors carry on the management of the company during the observation period and proceed with the restructuring of the company.

7.6 Rights retained by directors

7.6.1 In the event that the court orders the immediate judicial liquidation of the company at the commencement of the proceedings, pursuant to Article L. 641-9 of the French Commercial Code, a director of the company is not removed from his/her/its position but is immediately stripped of all rights of action, power and authority with respect to the activities of the company. All such rights of action, powers and authorities are vested in the judicially-appointed liquidator[91]. However, the Article provides certain exceptions. The company, through its directors, may form a civil party to criminal proceedings where the company has been the victim of the offence, and may carry out the acts and exercise the rights that are not included in the powers of the liquidator or the administrator when appointed. As the director remains in his/her/its office, there is no need to appoint an *ad hoc* representative to exercise these rights[92]. In practice, this scope of action is relatively limited as the liquidator will, among his/her other powers, usually be granted all powers, in respect of the assets of the company.

7.6.2 In all other insolvency proceedings (safeguard and judicial reorganisation), the director remains at the head of the company with varying degrees of power and authority over the conduct of the company's activities, depending upon the nature of the objectives granted to the judicially-appointed administrator (see 7.6.4 below).

7.6.3 Within this scope, the principal powers retained by directors are 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 formal notices (*mises en demeure*) to debtors of the company, and the creation or renewal of guarantees, charges and other encumbrances. 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.

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[91] Article L. 641-9 of the French Commercial Code.

[92] The director is allowed to receive the judgments' notifications and the notification of a certificate for the admission of a claim.

(ii) The power to undertake acts in the ordinary course of business of the company: Articles L. 622-3 and L. 631-14 of the French Commercial Code (applicable to both safeguard and judicial reorganisation proceedings) provide that subject to the prohibited acts listed below under section 7.7.1 and the acts considered within the scope of the administrator's objectives, acts taken in the ordinary course of business by the company alone, through its directors, *"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.622-3 of the French Commercial Code are those which fall within the scope of the normal business activities of the company, which are of such a nature as to occur and recur 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 the issuing of orders for office supplies of minor financial significance, the issuing of orders for materials necessary for the conduct of the company's business for amounts that are ordinary for the company, and the sale of goods typically sold by the company on normal terms and conditions. The third party must be act good faith which means that it must not be aware of any restrictions on the director of the company undertaking the act in question. It is not however typically necessary for the third party to have undertaken any specific investigation into the powers and restrictions actually affecting the director to prove its good faith.

7.6.4 The extent and nature of the other powers of directors with respect to the activities of the company in question depend upon the nature of the objectives granted to the administrator. These objectives will differ depending on whether the company is subject to safeguard or judicial reorganisation proceedings.

During safeguard proceedings, the court determines the extent of the objectives of the administrator which will be limited to two powers (Article L. 622-1-II of the French Commercial Code):

(i) the power to supervise the director in his/her/its management of the company: under this power, the administrator has as objective to prevent damaging decisions being taken by the director of the company; and

(ii) the power to assist the director in all or some of that persons management powers; the court exercises its discretion in this respect, taking into account the needs of the company: here, the company is truly managed by means of strict collaboration between the administrator and the director. This power may involve areas such as the redundancy or dismissal of employees, the management of bank accounts and the bringing and defending of claims.

During judicial reorganisation proceedings, the court also determines the extent of the powers of the administrator to either:

(i) fully manage the business and represent the company: even though Article L. 631-12 of the French Commercial Code does not specifically provide that the administrator will represent the business, the power of full management of the company means that the administrator will be fully and solely managing, and therefore representing, the company. (This means for example that the administrator will be the one bringing claims on behalf of the company, and claims against the company should be addressed to the administrator); or

(ii) assist in all or part of the management of the business: as with safeguard proceedings (Article L. 631-12 of the French Commercial Code) but will not include the power to supervise as with safeguard proceedings.

7.7 Acts that directors cannot undertake

7.7.1 The acts which the director is prohibited from taking as a general matter are the following:

(i) the director cannot pay debts incurred prior to the opening of insolvency proceedings except by way of set off of related claims, and any such payment is at risk of being held void (Article L.622-7 of the French Commercial Code). Except for a very limited number of exceptions specifically provided for by law, the payment of any such debts must receive the prior approval of the *juge-commissaire*;

(ii) Article L. 622-7 of the French Commercial Code also provides that the director cannot pay debts incurred after the opening of the insolvency proceedings which are not mentioned under Article L. 622-17 of the French Commercial Code which requires that they have to have been incurred in the sole interest of carrying on the business activities of the company;

(ii) the director cannot pay any debts incurred outside the ordinary course of business of the company in question (Article L.622-7 of the French Commercial Code). This prohibition is of course the corollary to the right of the director 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 the entering into settlement of a dispute becomes necessary, it must receive the prior approval of the *juge-commissaire*;

(iii) the director is prohibited from granting any form of security over the assets of the company without the prior approval of the juge–commissaire (Article L.622-7 of the French Commercial Code);

(iv) the director cannot take any decision with respect to the continuation or cessation of existing contracts binding the company to its customers or suppliers, such right of decision being vested in the administrator (Article L. 622-13 of the French Commercial Code);

(v) in the context of reorganisation proceedings, lay-offs may be made only after consultation with the juge–commissaire (Article L. 631-17 of the French Commercial Code);

(vi) the administrator, in agreement with the debtor, or the debtor alone with the authorisation of the liquidator, has the power to pay the price for goods purchased prior to the commencement of the insolvency proceedings but subject to a retention of title clause[93]. This is due to the fact that a contract with a retention of title clause is treated the same as a claim that is incurred after the opening of the proceedings.

[93] Article L. 624-16 of the French Commercial Code.

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 (signed in Rome on 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 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 an insolvency context, a 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 are 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 such interference is justified by a limited aim and/or is 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 privacy; and

(iv) Protocol 1, Article 1 – right to protection of property.

7.8.5 An example of certain inconsistencies between the Convention Rights and French insolvency proceedings relates to the right to a fair trial provided for under Article 6 of the Convention, where individuals or companies enjoy a range of rights, including in particular: (i) to be heard before a tribunal in order to determine their civil rights and obligations, and (ii) for the judge to be independent and impartial, which are two notions that may be seen as limited in the context of French insolvency proceedings.

(i) Right to access the French court in insolvency proceedings

Under French insolvency law, the right to bring claims and rights of appeal are in some circumstances limited; for example, the absence of the right for creditors to bring individual claims after the opening of insolvency proceedings against the insolvent company (with limited exceptions) (Article L. 622-21 of the French Commercial Code).

France was held liable by the European Court of Human Rights (the ECHR) in its decision *Arma v. France*, dated 8 March 2007, where the French court held that a director could not appeal against a decision opening judicial liquidation proceedings against the company. The French court based its decision on the fact that the decision opening judicial liquidation also ordered the dissolution of the company and this constituted the end of the office of directorship and that therefore the director did not have the power or interest to form an appeal against the decision. The ECHR held that this was contrary to Article 6 of the Convention. Reform of French law in 2006 rectified this point; for proceedings opened after 1 January 2006: the director remains in office on the opening of liquidation proceedings unless provided otherwise in the articles of association or by a shareholders' decision.

(ii) Right to an independent and impartial judge

The question of whether a person's right to an independent and impartial judge is respected during French insolvency proceedings involves consideration of the jurisdiction of the *juge-commissaire* and the insolvency court and also the make-up of the insolvency court itself.

Under French law, the *juge-commissaire*, an organ in the insolvency proceedings that is also referred to in practice as the *"orchestra conductor"*, has certain powers including, for example, the power to approve creditor claims. This *juge-commissaire*, outside of this role may also be part of the composition of the insolvency court. The ECHR will review all facts to evaluate whether the presence of the *juge-commissaire* in the composition of the insolvency court breaches the right to a fair trial. It will be regarded as relevant that the *juge-commissaire* granted orders relating to the management of a group of companies during an observation period and at the same time presided over the insolvency court in charge of determining whether the business plan (plan de continuation) is itself viable[94]. The *juge-commissaire* will not always have a dual role. Pursuant to Article L. 651-3 of the French Commercial Code, the *juge-commissaire* may not be a member of the insolvency court for claims against directors in respect of a shortfall of assets.

In most cases, the insolvency court is the commercial court which is composed of practitioners being business men and women, who may be competitors or friends of the directors or shareholders of the insolvent company. This danger of being seen to be potentially partial was highlighted in a case where a number of members of the commercial court actually participated in the operations of the company that was placed in judicial reorganisation[95]. In this case, the court decided to quash the decision of the Commercial Tribunal of Carcassonne because the judges were not impartial and independent on the basis of the Article 6 of the ECHR.

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[94] ECHR, 6 June 2000, *Morel v. France:* Here the ECHR decided that it needed to be determined objectively on the facts whether the *juge-commissaire* was impartial due to the fact he had taken measures during the observation period and he was also seated as president of the insolvency tribunal deciding on the outcome for the company. On this basis, the ECHR held that the impartiality of the *juge-commissaire* depended on the extent of the measures ordered during the observation period and that on the facts the *juge-commissaire* in this case was impartial.

[95] Court of Appeal of Montpellier, 8 July 1992, *Société Le Vicomte v. Rey*.

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 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 Criminal bankruptcy (banqueroute) and fraudulent organisation of insolvency fall within the category of offences known as délits correctionnels. The applicable limitation period is three years. Article L. 654-16 of the French Commercial Code provides that the limitation period starts to run only from the date on which formal bankruptcy proceedings have been opened if the incriminating facts occurred prior to that date. This Article of the Commercial Code, however, does not indicate the date from which the limitation period begins to run for such criminal proceedings where the incriminating facts occurred after the commencement of formal insolvency proceedings. For criminal proceedings, the limitation period is of utmost importance and therefore, the majority of French academics believe this omission to be deliberate so that the limitation period for such incriminating facts would be the period provided under general principles of criminal law. This is the period starting on the date on which these incriminating facts were discovered or took place. If the view is taken that it should be the same date as for other similar corporate offences, the limitation period would commence on the date the incriminating facts were discovered.

Limitation period for civil proceedings

8.1.2 Civil liability claims for the shortfall of assets are barred three years after the date on which the court orders judicial liquidation.[96]

It should be noted that if a claim is brought against one director, this claim does not bar the possibility of bringing another civil liability claim for the shortfall against another director of the same insolvent company if the directors are not severally liable[97].

8.1.3 Civil liability claims for personal bankruptcy are also barred after three years from the date of the court decision opening the judicial reorganisation or judicial liquidation, as appropriate[98].

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[99]. Only the director in question, the civil party, the public prosecutor or the general public prosecutor of the Court of Appeal may bring an appeal. Where the director is present at the hearing at which the judgment is rendered at first instance, the period for appeal is 10 days from the date of the judgment[100]. However the period of appeal runs from the date the judgment was served where the director in question was judged in his or her absence (but after having heard a counsel that was present to ensure the director's defence without having the letter of instruction signed by the director).

Appeal in civil proceedings

8.2.2 Pursuant to Article R. 661-6 of the French Commercial Code, judgments holding directors liable for the shortfall of assets or personal bankruptcy may be subject to appeal by the director in question by application of the applicable general civil procedural rules. The director's appeal must be made to the Court of Appeal of the district in which the first instance court was sitting. The appeal must be filed within ten days of the date on which the judgment at first instance was notified to the director[101].

Pursuant to Article L. 661-11 of the French Commercial Code, judgments holding directors liable for the shortfall of assets or personal bankruptcy may be subject to appeal by the public prosecutor and the general public prosecutor of the Court of Appeal even if neither of them were the main claimants in the case[102]. The appeal must also be filed within ten days, but ten days from the date the public prosecutor receives notification of the judgment from the court clerks[103].

[96] Article L. 651-2 of the French Commercial Code.
[97] Cour de cassation, 7 November 2006, n° 05-16.693.
[98] Article L. 653-1 of the French Commercial Code.
[99] Article 496 of the French Criminal Procedural Code.
[100] Article 498 of the French Criminal Procedural Code.
[101] Article R. 661-3 of the French Commercial Code.
[102] Articles L. 661-11 and L. 661-12 of the French Commercial Code.
[103] Article R. 661-3 of the French Commercial Code.

QUESTION 9

9. Foreign corporations

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

9.1 Introduction

The court which has jurisdiction over civil claims brought against directors is the court which has jurisdiction over insolvency proceedings.

The French criminal court has jurisdiction over criminal claims against directors of a company under formal insolvency proceedings commenced in France.

Given the above it is essential to determine which court has jurisdiction over insolvency proceedings.

Insolvency proceedings can be commenced in France in respect of a foreign corporation pursuant to:

(i) the EU Regulation on European insolvency proceedings (the EU Regulation), and

(ii) international treaties; or

(iii) French laws on insolvency matters[104] for international non-European insolvency proceedings (French private international law).

9.2 European insolvency proceedings

9.2.1 Since 31 May 2002, EU Regulation n° 1346/2000 has replaced the former law, that is, international treaties and national French laws on insolvency matters concerning entities located in the EU. The EU Regulation applies to "European Insolvency Proceedings"[105] (that is, insolvency proceedings which are included within the scope of the EU Regulation in relation to a company[106] which has its centre of main interest or COMI in a Member State of the EU, with the exception of Denmark). An insolvent company's COMI will therefore determine in which country the main insolvency proceedings can be commenced.

The EU Regulation provides for two distinct sets of proceedings: main proceedings and secondary proceedings. Main proceedings concern all of the insolvent company's assets, whether they are located in the jurisdiction in which the main proceedings have been opened, or are located in another EU Member State. Secondary proceedings concern only the assets of the insolvent company located in the Member State where the secondary proceedings have been commenced. The debtor's COMI is of critical importance in determining where the main proceedings take place, but COMI is not defined by the EU Regulation.

9.2.2 Despite the lack of a definition of COMI, the EU Regulation provides some guidance in its recitals that a debtor's 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*[107]*"* and that where the debtor is a company, its COMI is to be deemed to be located at the place of the company's registered office[108].

One of the questions that previously remained unanswered concerned how strong the registered office presumption was where, in the objective view of third parties, the registered office was not located in the place where the company operates its business. This question was answered by the Court of Justice of the European Union (CJEU) in the *Eurofood* case[109] where it firstly held that the COMI should be an autonomous and uniform concept, meaning that the COMI should be applied and interpreted in each Member State, independently of any national legislation. Secondly, the CJEU in *Eurofood* to an extent limited the scope of the rebuttal of the registered office presumption by stating that the presumption may only be rebutted *"if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from that which locating it at that registered office is deemed to reflect."*[110]

[104] See (commercial chamber of the Cour de cassation, 15 February 2000 (appeals number: 97-16770 & 97-14415), 22 March 2011 (appeal number : 10-14889), 22 May 2012 (appeal number : 11-14366).

[105] The EU Regulation only applies to proceedings of insolvency which involve the appointment of an administrator, that is to say, as far as French proceedings are concerned, liquidation and judicial reorganisation, i.e. *redressement judiciaire* (Annex A of the EU Regulation).

[106] Credit institutions, insurance undertakings, investment undertakings holding funds or securities for third parties and collective investment undertakings are excluded from the scope of the EC Regulation. (Considering (9) of the EC Regulation's preamble). Credit institutions are subject to EC Regulation 2001/24/CE dated 4 April 2001 (see articles L. 613-31-1 et seq. of the French Monetary and Financial Code); insurance companies are subject to EC Regulation 2001/17/CE dated 19 March 2001 (see Order n° 2004-504 dated 7 June 2004); investment undertakings holding funds or securities for third parties and collective investment undertakings are subject to EC Regulation 2004/39 dated 21 April 2004 and EC Regulation 2009/65 dated 13 July 2009.

[107] Recital 13 of the EU Regulation.

[108] Article 3(1) of the EU Regulation.

[109] CJEU, *Eurofood*, number C-341/04, dated 2 May 2006.

[110] Ibid.

The position of the CJEU in the *Eurofood* case was confirmed and expanded upon by the CJEU in the *Interedil* case[111]. The CJEU held that:

> A debtor's COMI must be determined by attaching greater importance to the place of the company's central administration, as may be established by objective factors which are ascertainable by third parties. Where a company's registered office and place of central administration are in the same jurisdiction, the registered office presumption cannot be rebutted. Where a company's central administration is not in the same place as its registered office, the presence of assets belonging to the debtor and the existence of contracts for financial exploitation of those assets in a Member State, other than that in which the registered office is situated, are not sufficient factors to rebut the registered office presumption, unless a comprehensive assessment of all the relevant factors makes it possible to establish, in a manner that is ascertainable by third parties, that the company's central administration is located in that other Member State.

9.2.3 One common issue that directors can face, when they are a director of various companies within the same group that are registered in different States, is that different legal regimes are likely to govern their duties as director of each company. The EU Regulation does not make any reference to group companies and, therefore, it was debatable whether the EU Regulation could be used to place all companies within the same group into insolvency proceedings in the same jurisdiction (thus potentially avoiding the problem highlighted above). However, where each group company has its COMI in the same Member State (normally the State where the parent company is located) the courts of that Member State have on a number of occasions been able to place each company into insolvency proceedings in the same jurisdiction - rebutting the registered office presumption when doing so. This approach was found to be valid by the CJEU in *Eurofood*.

The French courts are a good example of courts that refer to the decisions of the CJEU and will rebut the registered office presumption in appropriate circumstances. A good example of the French court rebutting the registered office presumption was the Eurotunnel case.

The Eurotunnel group, comprised of seventeen companies with the parent's registered office located in France, was experiencing financial difficulties where every company of the group was unable to reimburse the loans to which they were subject. This case has been debated extensively by numerous academics on the basis that, arguably, the Commercial Court of Paris, ruling on the facts, overlooked certain facts that could have led to the conclusion that the COMI of a number of the subsidiaries should have been located at their own registered office (ie not in France but in another Member State).

Of course, the court's decision that the COMI of all subsidiaries was located at the registered office of the parent company facilitated the efficient and effective restructuring of the group.

Another example of a case in front of the French courts is the Coeur Défense case where the French subsidiary of a Luxembourg parent company found itself in financial difficulty and in breach of its financing agreements. The French subsidiary and the Luxembourg parent company both requested the opening of safeguard proceedings which were opened by the Commercial Court of Paris. This case was concluded by the Court of Appeal of Versailles on 19 January 2012 after being referred back to it from the Cour de cassation. The Court of Appeal referred to the *Eurofood* and the Interedil decisions of the CJEU to come to a ruling that, based on "a global appreciation of the pertinent elements", the Luxembourg-based parent company was actually managed from Paris.

In light of the lack of definition of COMI, the absence of any reference to group companies and the resistance of certain national courts, including French courts, to comply strictly with the CJEU's interpretation of the EU Regulation, the EU Regulation is in the process of being reformed.

On 12 December 2012, the European Commission submitted a proposal to amend the EU Regulation. These proposals contain, among others, provisions which would essentially provide legislative confirmation of the CJEU decisions in *Eurofood* and Interedil. The proposals would not create a separate procedure for EU group insolvencies.

The proposal will be reviewed by the European Council and Parliament and any amendment to the Regulation will be adopted following the procedure provided in European Union Treaty. Any reforms to the EU Regulation will most certainly take in excess of two years to come into force[112].

9.3 International non-European insolvency proceedings

9.3.1 Where the EU Regulation does not apply, the question of whether insolvency proceedings can be commenced in France will depend on whether there is an international treaty governing the matter. If there is no international treaty the matter will be governed by French private international law. The number of treaties that remain in force has considerably decreased since the EU Regulation came into force; as this Regulation has replaced all the bilateral treaties concluded by EU Member States. To our knowledge, the only bilateral treaty that remains applicable is the treaty entered into between France and Monaco dated 13 September 1950 and effective since 12 July 1952. Pursuant to Article 2 of this bilateral treaty, jurisdiction to commence insolvency proceedings lies with the court with jurisdiction in the location of the registered office of the insolvent company. If the registered office of the insolvent company is, however, not located in France or in Monaco, then the court having jurisdiction is the court that has jurisdiction in the location of the insolvent company's principal establishment.

9.3.2 French private international law adopts a mixed approach to cross-border insolvencies, being more favourable to the jurisdiction of the French courts and therefore to the application of French law. Under French private international law, the French courts may be able to open insolvency proceedings in respect of a company with its registered office located in France or where the insolvent company has its centre of main interests (as defined in French law *"le centre principal de ses intérêts"*) meaning, in most cases, that its main establishment (*établissement principal*) is in France.

Pursuant to Article R. 600-1 of the French Commercial Code, French courts may have jurisdiction over cross-border insolvency proceedings effective over all assets of the insolvent company, even those located abroad.

[111] CJEU, *Interedil*, number C-396/09.
[112] Article 251 of ECT, 24 December 2002.

Furthermore, even though the minimal condition to commence insolvency proceedings in France is for an establishment to be on French soil, in order to protect rights of French creditors, the French courts have held in the past that they had jurisdiction resulting from the "presence of commercial relations"[113] or even the presence of real estate that may not even be allocated to a business activity of the insolvent company[114]. Nevertheless, these cases were one-off cases that have not been followed since. In more recent times, the French courts have been more cautious when applying national law to cases with an international dimension and therefore, it is questionable whether the case law from these two cases would still apply today.

9.3.3 Despite the will of French law and French courts to have jurisdiction and apply French national law to cross-border insolvency proceedings, French courts are limited by decisions of foreign courts ruling on the cross-border insolvency that have been granted *exequatur,* requiring the acknowledgement and enforcement of the foreign court decision in France.

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 coverage

Under French law, a company may take out insurance and pay insurance premiums in respect of the civil liability of its directors. Insurance policies for directors are called RCMS or D&O (Directors and Officers Liability). These types of insurance policies are not considered as contracts which are regulated by Article L. 225-38 of the French Commercial Code and therefore, do not need the prior approval of the board if the company is incorporated in France.

10.2 Insurance and criminal liability

Pursuant to Article L. 113-1 of the French Insurance Code, which provides: "*[…] the insurer shall not be answerable for loss and damage caused by the insured's deliberate tortious, intent or fraud"*, these insurance policies do not cover intentional fault. French courts interpret strictly this notion of the insured's deliberate tortious, intent or fraud. Directors who act with the intention/purpose of causing damage will not be covered by the insurance policy. As the intention relates to the damage, directors who take risks associated with the operation of their duties will still be covered by such insurance policies as long as their intent was not to damage the company[115]. Insurance policies shall at all times cover *de jure* directors and their heirs (for example, the liability of a deceased director). Insurance policies may also cover *de facto* directors depending on how the insurance policy is drafted. If the policy states the names of the *de jure* directors, only those who are named will be covered. It is recommended that insurance policies expressly provide for which types of directors are covered by the policy, and this should be negotiated at the time of taking out the coverage. Insurance policies can therefore cover (if expressly provided for): *de jure* directors, *de facto* directors, newly appointed directors, as well as retired directors[116].

These insurance policies do not cover directors who are found guilty of criminal offences or for fines ordered by the criminal courts. However, insurance policies may cover:

- the legal fees incurred for legal assistance to the director in court; but if the director in question is found guilty from a criminal perspective, the insurance company may bring a claim against the director to cover the costs it incurred by covering the legal fees paid out to the director's lawyers; and

- compensation granted by the criminal court to the civil party that attached their civil claim to the criminal proceedings, but only if there is no presence of intentional fault as mentioned above (i.e. Art. L.113-1 of the French Insurance Code).

The coverage by insurance policies of civil liability consequences arising out of a criminal claim in front of a criminal court is further justified by the reform of Article 4 of the French Criminal Procedural Code by law n°2007-291, dated 5 March 2007, making the principle that *"criminal prevails over civil"* more flexible. As a result of this reform, a second paragraph was added to Article 4 of the French Criminal Procedural Code to temper the above principle. This paragraph states *"the public prosecution's initiative of the proceedings does not enjoin the suspension of judgment of the other actions of any kind exercised before the civil courts, even if the decision of the criminal court may directly or indirectly influence the decision to be held in the civil proceedings"*[117].

10.3 The insurance policy will usually cover all actions of the directors although some actions may be specifically excluded. These kinds of contracts are referred to as *"assurance tout sauf"* (insurance with full coverage with limited listed exceptions where the policy will not apply). Normally, mismanagement is covered in the General Conditions of such insurance contracts, but it may be more prudent to specifically state that mismanagement is covered by the specific policy, regardless of whether the mismanagement was committed within or outside of the director's management role.

10.4 Existence of a cap and possible reimbursement

All insurance policies have a cap on liability for damages. Where an insurance policy does not provide comprehensive cover of all risks, it is permissible to enter into several insurance policies to ensure comprehensive coverage. This kind of process is called *assurances multilignes*.

[113] Cour de cassation 14 April 1934.
[114] Commercial Chamber of the Cour de cassation 26 oct. 1999, n°96-12.946.
[115] Civil Second Chamber of the Cour de cassation, 1st July 2010, n° 09-10.590.
[116] G.Greff, La responsabilité des dirigeants retirés RTD Com. 1978.
[117] Article 4 of the French Criminal Procedure.

It is important to note that any person who has suffered a loss due to a director's mismanagement has a direct right to claim for damages against the insurance company[118]. Where such a direct claim is brought by a victim, if the mismanagement of a director is not covered by the policy, the insurance company is subrogated to the rights of the victim, and can seek reimbursement from the director.

Where an insolvency procedure is opened, the risk for the insurance company of having to pay for a mismanagement claim increases. That is why in some policies, a specific termination clause is inserted with regard to the opening of an insolvency procedure. However, despite the fact that this clause is present in many insurance policies, the mechanisms of Article 80 of the Law n°2003-706 on Financial Security, dated 1 August 2003 mean that this type of clause is no longer effective.

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 duties of directors and *de facto* directors are considered above in the response to Question 2. As noted in that answer, French law does not focus on the types of transactions but rather on sanctions that may be imposed on 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 such director being exposed to liability lies in the circumstances in and the reasons for which such further credit was incurred, rather than in the type of transaction through which such credit was obtained.

11.1.2 Consequently, if by incurring further credit, a director commits an act of mismanagement (for example, there was no good reason for the company to incur such credit or to acquire a costly asset financed by credit) or did so for his or her own personal ends and not for the company, that director would be exposed to a civil liability claim for the shortfall of assets 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 in question 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 due and owing debts.

11.1.4 Given the technical nature of the definition of cessation of payments and the risk that the date of cessation of payments may be fixed retroactively by the insolvency court, it is possible (generally only for companies which do not have appropriate financial monitoring processes) for a director to be running a company in a state of cessation of payments without knowing that to be 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 directors will get independent professional help, whether from insolvency practitioners, legal professionals, accountants and/or 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. 632-1 and L. 632-2 of the French Commercial Code provide for a series of different types of acts which will either be null and void or voidable at the discretion of the court if undertaken during the "twilight" or, in French terminology, the "suspect" period – a period which can extend to 18 months prior to the date of the commencement of formal insolvency proceedings or 24 months in the case of transactions 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. It is thus clear under French law that a party transacting with a company that is or is likely to be in a state of cessation of payments must avoid each of the 11 different types of transaction listed in Article L. 632-1 of the French Commercial Code. Failure to do so will result in the automatic avoidance of the transaction and the concomitant measures of restitution required against the third party. It should be noted that the causation of loss to the company is not a condition for the applicability of Article L. 632-1 of the French Commercial Code, neither is bad faith nor any form of wilful intent or knowledge that the company is in a state of cessation of payments on the part of the third party.

11.2.3 Again as noted above in response to Question 4, the courts have a discretionary right to avoid any transaction entered into during the twilight period in circumstances where the other party was aware of the fact that the company was in a state of cessation of payments. The apparently draconian nature of this power is tempered by the need to show that the counterparty was aware not only that the company was in financial difficulties but that it was in the technical and special position of having an amount of available assets less than the amount of its due and payable debts. According to French case law, available assets comprise assets that are available immediately or within a short period of time[119]. For example, any claims that need to be recovered are in principle excluded from the notion of "available assets"[120].

[118] Article L. 124-3 of the French Insurance Code.
[119] Rapport drafted by Mr.Xavier de Roux, n°2095, p.339.
[120] Paris, 3° ch. B, 8 November 2007, RG n°07/08101.

Appendix

Overview of French pre-insolvency and insolvency procedures

I. Preventive measures before insolvency proceedings

With the aim of preventing businesses going into insolvency, French law provides for two different but similar proceedings for companies experiencing financial difficulties or anticipating foreseeable financial difficulties: the *mandat ad hoc* and *conciliation* proceedings.

1. ***Mandat*** *ad hoc*

The *mandat ad hoc* is a procedure (a special mediation process) which enables companies experiencing difficulties to avoid insolvency proceedings by instigating confidential negotiations, usually with their main creditors, with the assistance of a third party, the *mandataire ad hoc*.

1.1 Filing[121]

Any debtor[122] facing difficulties, usually of a financial, economic or legal nature but without being in cessation of payments, may file a motion (*requête*) with the president of the local court to appoint a *mandataire ad hoc*. The motion must be in writing and set out the grounds for the request. Certain other documents must also be filed which are along the same lines as for the *conciliation* procedure below.

1.2 Appointment and Remuneration of the ***Mandataire*** *ad hoc*

If a company requests the appointment of a *mandataire ad hoc*, it can propose the appointment of a specific person. However, the president of the local court can refuse the proposal. This will depend on the practice of local court. The president of the court is nevertheless limited in its choice of *mandataire ad hoc*. A person who has received, directly or indirectly, a remuneration or payment from the debtor, or a person who controls or is controlled by the debtor, (or has done so within the last 24 months) may not be appointed as *mandataire ad hoc*[123].

The president of the court will also fix the remuneration of the *mandataire ad hoc*, having approved this with the debtor.

1.3 Objectives of the Mandataire *ad hoc*[124]

On the appointment of the *mandataire ad hoc*, the president of the court will determine its objectives and powers. These will normally be to:

- assist the company in its negotiations with creditors, employees and all other relevant commercial partners, including, when required, the main shareholders;
- help the company to evaluate its financial situation;
- try to resolve these difficulties; and,
- report back to the president of the court.

1.4 The main advantage of the mandat *ad hoc* procedure

The main advantage of this process is that it remains confidential and is very flexible - the process is not legally limited in time[125] and the *mandataire ad hoc* is appointed to assist the directors who remain in charge of the company's management.

1.5 Stay of proceedings

Under a *mandat ad hoc*, the only way a debtor can stay proceedings is by contractual agreement with the creditors concerned.

1.6 Outcome of mandat *ad hoc* proceedings

Even if the company comes to an agreement with some of its creditors, this will not affect the company's other creditors or commercial partners who remain outside the agreement and who will be entitled to take legal action as they see fit to recover sums due to them.

Therefore, it is common for the *mandat ad hoc* to be followed either by *conciliation* proceedings to render these agreements enforceable by court or by safeguard proceedings under which a restructuring plan may be adopted. (See section II 1.4.1 below.)

[121] Article L. 611-3 of the French Commercial Code.
[122] For the sake of simplicity, we will consider hereafter that the debtor is a commercial company.
[123] Article L. 611-3 of the French Commercial Code.
[124] Article R. 611-19 of the French Commercial Code.
[125] Article R. 611-21 of the French Commercial Code.

2. Conciliation proceedings

Conciliation is a confidential procedure[126] available to companies experiencing legal, economic or financial difficulties or likely to experience such difficulties in the future. Unlike the *mandat ad hoc*, *conciliation* is also available to companies which have been in cessation of payments for less than 45 days[127].

2.1 Filing[128]

The director of a company may file a motion (*requête*) with the president of the local court requesting the appointment of a conciliator. The motion must be made in writing and set out the financial, economic and social difficulties of the company, its financing needs and proposals to deal with its difficulties.

Certain corporate and financial information must be filed with the motion, as set out in Article R. 611-22 of the French Commercial Code. If the company is in cessation of payments, this will also need to be mentioned in the motion, including the date on which cessation of payments began.

2.2 Appointment and Remuneration of the Conciliator[129]

The appointment of the conciliator is very similar to the appointment of the *mandataire ad hoc* whereby the president of the local court:

– appoints a conciliator of its choice (within the limits provided by the Commercial Code[130]); and,

– determines the remuneration of the conciliator, having agreed this with the director of the company[131].

– The debtor may suggest a conciliator but the president of the local court is not obliged to take this suggestion into account.

2.3 Objectives of the Conciliator[132]

The conciliator's role is to put an end to the company's difficulties by promoting and encouraging the debtor company to enter into an amicable agreement with its main creditors and, if applicable, its usual commercial partners.

It is not the conciliator's role to assist the directors in managing the company or to supervise the company, nor does the conciliator have the power to impose a *conciliation* agreement, although the conciliator may put forward suggestions regarding running the business and maintaining employment levels.

The conciliator must report back to the president of the local court on the progress of the *conciliation* and on any useful information concerning the debtor.

2.4 Duration

2.4.1 Time Constraints[133]

The conciliator is appointed for a maximum of four months, with a possible one month extension.

At the end of this period, it is not possible to open another *conciliation*, until three months have passed. It is therefore not uncommon for companies to file for a *mandat ad hoc* during this three month period or to start with a *mandat ad hoc* and then open *conciliation* proceedings.

2.4.2 Stay of proceedings

Since *conciliation* proceedings are not insolvency proceedings, there is no stay on individual proceedings. Creditors may bring individual proceedings against the debtor during *conciliation*, including enforcement proceedings. However, creditors will often agree to a temporary postponement of proceedings.

Furthermore, the French Commercial Code provides companies with limited protection against creditor claims during the *conciliation* by permitting a company to request the president of the local court to postpone or spread out payments due to creditors for a period of up to two years[134].

2.5 Outcome of conciliation proceedings

2.5.1 *Conciliation* Agreement

When the company reaches an agreement (a *conciliation* agreement) with one or more of its creditors or commercial partners, it may apply to the president of the local court or to the local court to have the agreement acknowledged (*constaté*) or approved (*homologué*).

[126] Article L. 611-15 of the French Commercial Code.
[127] Article L. 611-4 of the French Commercial Code.
[128] Article L. 611-6 of the French Commercial Code.
[129] Article L. 611-6 of the French Commercial Code.
[130] Article L. 611-13 of the French Commercial Code.
[131] Article L. 611-14 of the French Commercial Code.
[132] Article L. 611-7 of the French Commercial Code.
[133] Article L. 611-6 of the French Commercial Code.
[134] Articles L. 611-7 of the French Commercial Code and1244-1 of the French Civil Code.

2.5.1.1 Acknowledgement of the *conciliation* agreement

The debtor may opt for the acknowledgement of the *conciliation* agreement by filing a joint motion with those creditors who are party to the agreement with the president of the local court. To accelerate the process, creditors may authorise the company to file the motion on their behalf.

Before acknowledging the agreement, the president will check that the *conciliation* agreement exists and that the company has declared that it is not in cessation of payments or will no longer be by entering into the agreement. The president does not look into the content of the agreement so it remains confidential.

On acknowledgement of the agreement, it is filed at the court registry where all parties to the agreement may obtain an official copy. The content of the agreement remains confidential as the court registry will not provide copies to third parties[135].

The acknowledged agreement does not affect third parties, including creditors who are not a party to it. Such creditors may still bring claims against the company for payment of sums due to them.

The main purpose of the acknowledgement of the *conciliation* agreement is to make the agreement enforceable against the creditors who are party to it, whilst the content and existence of the agreement remains confidential.

2.5.1.2 Approval of the *conciliation* agreement[136]

Alternatively, the company may opt for the approval of the *conciliation* agreement. In this case, the existence of the agreement will be published by the court but the content will remain confidential[137].

The motion for approval must be filed before the end of the *conciliation* period.

The directors of the company, the creditors who are party to the *conciliation* agreement, the directors of the workers' council, the conciliator and the public prosecutor[138] must all be given notice of the approval proceedings.

To obtain approval, the company must satisfy three conditions:

- the company is not in cessation of payments or will no longer be in this state by entering into the agreement;
- the terms of the agreement will achieve continuity of the company's business;
- the interests of creditors who are not party to the agreement are protected.

Once satisfied in respect of these three conditions, the court's judgment containing its approval of the *conciliation* agreement will be filed at the court registry, where any interested party can access it[139].

The main reason for getting the *conciliation* agreement approved is because of the consequences/benefits (see below) if the debtor subsequently goes into formal insolvency proceedings.

To this effect, debtors and creditors will normally seek to obtain the approval of a *conciliation* agreement (as opposed to an acknowledgement) for the following reasons:

- if creditors grant any new financing, services or goods to keep the company afloat, they will benefit from priority if the company subsequently enters into insolvency proceedings (a 'New Money Privilege')[140] ; and
- if the company enters into insolvency proceedings, the date of cessation of payments decided by the court will not pre-date the court's approval of the agreement[141] and therefore, the payments made and securities granted under the *conciliation* agreement cannot be declared null and void;
- certain guarantors of the company, may invoke the approved *conciliation* agreement against creditors who are party to the agreement. This applies to guarantors who have guaranteed a security (caution), are co-debtors, autonomous guarantors or have granted a personal security[142].

2.5.1.3 Waiver of part of the claim of creditors in the public sector

In certain circumstances, the debtor may obtain a waiver from its public creditors as to part of their claims, pre-emption rights, and position in the ranking of creditors as holders of a charge or mortgage (See Section 3.3.2).

2.5.2 Failure of the proceedings

2.5.2.1 No *Conciliation* Agreement

In the event the conciliator does not obtain creditor approval to enter into a viable *conciliation* agreement, the president of the local court will bring the *conciliation* proceedings to an end[143].

If the conciliator concludes in his report that the company is in cessation of payments, the court will, on its own initiative, open judicial reorganisation proceedings or judicial liquidation proceedings (where it concludes that judicial reorganisation proceedings will not save the business)[144].

[135] Articles L. 611-8 of the French Commercial Code and R. 611-39 of the French Commercial Code.
[136] Article L. 611-8, II of the French Commercial Code.
[137] Article R. 611-40 of the French Commercial Code.
[138] Article L. 611-9 of the French Commercial Code.
[139] Article L. 611-10 al 2 of the French Commercial Code.
[140] Article L. 611-11 of the French Commercial Code.
[141] Article L. 631-8 of the French Commercial Code.
[142] Article L. 611-10-2 of the French Commercial Code.
[143] Article L. 611-7 al 6 of the French Commercial Code.
[144] Articles L. 631-4 and L. 640-4 al 2 of the French Commercial Code.

If the company is not in cessation of payments, the conciliator may file a motion to open accelerated financial safeguard proceedings which will force recalcitrant financial creditors to come to an agreement[145].

2.5.2.2 Refusal to approve the *conciliation* agreement

If the conciliator concludes in his report that the company is in cessation of payments, the court will, on its own initiative, open judicial reorganisation proceedings or judicial liquidation proceedings (where it concludes that reorganisation proceedings will not save the business)[146].

If the company is not in cessation of payments, it may still be possible to file a motion to obtain the acknowledgement of the *conciliation* agreement even where the approval of the *conciliation* agreement has failed.

II. Insolvency proceedings

1. Safeguard proceedings

When considering whether to enter into safeguard proceedings or to use pre-insolvency proceedings, it is important to evaluate the difference in level of assistance and interference in the company's management.

Safeguard proceedings are public proceedings, benefiting from more powerful tools than the pre-insolvency proceedings whereby recalcitrant creditors can be bound by the terms of a restructuring plan.

1.1 Filing

1.1.1 Motion[147]

Under safeguard proceedings, a company in difficulty but without being in cessation of payments may file a motion for the court's assistance and protection in order to turn itself around.

- Only the director of a company can file a motion to open safeguard proceedings.
- Safeguard proceedings may only be opened when the debtor is experiencing difficulties which it cannot overcome alone (*"difficultés qu'il n'est pas en mesure de surmonter"*).
- The court will look into the financial, economic, social and legal situation of the company (the turnover, the annual income, the implementation of a restructuring plan, etc.) as on the day of opening proceedings and not on the day the motion is filed[148].

1.1.2 Filing[149]

Certain corporate information and documents must be filed with the motion to open proceedings which must be dated, signed and certified as true by the company.

1.2 Players in the safeguard proceedings

1.2.1 The court-appointed administrator[150]

A court-appointed administrator will assist or supervise the company during safeguard proceedings. As with the *mandat* ad hoc and *conciliation* proceedings, the company may propose an administrator, but the court has the right to refuse this proposal and appoint an administrator of its choosing.

During the observation period, (see below), the company's business continues to be run by its directors under the supervision of the administrator. However, certain powers are vested in the administrator including whether the company's ongoing contracts (other than employment contracts) should be terminated.

1.2.2 The *juge-commissaire*[151]

Certain decisions (those not in the ordinary course of business or decisions as to sale of assets) require the prior approval of the juge-commissaire, the judge nominated to monitor the proceedings.

1.2.3 The *mandataire judiciaire*[152]

As well as the administrator, the court will also appoint a *mandataire* judiciaire, from the list of *mandataire*s judiciaries registered within the court's jurisdiction.

The *mandataire* judiciaire has one objective: to represent creditors' interests and, more specifically, to receive their claims and verify whether they exist.

1.2.4 The *controleurs*[153]

Additionally, up to five creditors may be appointed by the juge-commissaire as controleurs, if requested. The controleurs complement the role of the *mandataire* judiciaire in protecting the interests of creditors and assisting the juge-commissaire in its mission to supervise the running of the business.

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[145] Articles L. 628-1 to L. 628-7 of the French Commercial Code.
[146] Articles L. 631-4 and L. 640-4 al 2 of the French Commercial Code.
[147] Article L. 620-1 of the French Commercial Code.
[148] Commercial chamber of the Court de cassation 26 June 2007, n° 06-20.820.
[149] Articles R. 611-22 and R. 621-8 of the French Commercial Code.
[150] Articles L. 621-4 and L. 622-1 of the French Commercial Code.
[151] Articles L. 621-4 and L. 621-9 of the French Commercial Code.
[152] Articles L. 621-4 and L. 622-20 of the French Commercial Code.
[153] Article L. 621-10 of the French Commercial Code.

1.3 During the proceedings

The court will automatically stay all payments and all ongoing interest on payments (with limited exceptions, such as the enforcement of retention of title clauses and loans of more than one year), to grant the company a breathing space to draw-up a restructuring plan to be submitted to the court for approval.

The court will open an observation period which lasts six months and may be renewable once and in very limited circumstances, twice, for the purposes of preparing and obtaining the approval from the court on a restructuring plan. The observation period comes to end upon approval of the restructuring plan by the court.

1.3.1 Creditors' committees

Usually under safeguard proceedings, creditors' committees will be formed. The court has a discretion to create creditors' committees even where the required thresholds are not met (the same thresholds as for accelerated financial safeguard proceedings)[154].

The committees are composed as follows[155]:

- the first committee: trade creditors (suppliers who individually are owed receivables representing at least 3% of the total amount of the company's supplier liabilities);
- the second committee: banking establishments and financial and credit institutions (including hedge funds)[156] regardless of the size of their claim; and
- the third committee: bondholders, if any.[157]

The purpose of the committees is to allow the creditors to discuss and vote on the proposed restructuring plan[158].

1.3.2 Safeguard restructuring plan

With the assistance of the administrator, the company (through its directors) draws up a draft restructuring plan[159]. The term of the plan will be fixed by the court, subject to a maximum of ten years[160].

The plan is very flexible, for example by allowing the company to treat each committee differently if economically justifiable to do so.

The restructuring plan may provide for[161]:

− the postponement of repayment of claims;
− the reduction or full relief from interest payments;
− debt forgiveness also known as "debt cram down";
− debt for equity swaps, meaning the conversion of claims into equity/shares if the debtor is a joint stock company (société par actions);
− reserved increase of share capital; and
− the issuing of convertible bonds (obligations convertibles en actions).

1.3.3 Partial waiver of claims of creditors in the public sector[162]

The debtor may obtain a waiver from its public creditors as to part of their claims, pre-emption rights, and their ranking between creditors holding a charge or mortgage.

1.4 Outcome of the safeguard proceedings

1.4.1 Approval by creditors and the court of the draft restructuring plan

Not all creditors will vote on the proposed restructuring plan. Creditors will not vote if

- the plan does not modify their payment terms;
- their claim is to be fully reimbursed in cash pursuant to the plan[163].

All committee creditors vote in their respective committee and the approval threshold is two thirds of the total value of the claims of all the creditors who actually vote. If this majority is achieved, the dissenting minority will be bound by the decision of the majority[164].

Voting must take place in each committee within 20 to 30 days of receiving the draft plan[165] and within six months from the opening of safeguard proceedings[166].

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[154] Article L. 626-29 of the French Commercial Code.
[155] Article L. 626-30 of the French Commercial Code.
[156] Pursuant to Article L. 626-30 of the French Commercial Code, hedge funds all credit institutions and those assimilated to these institutions, as well as all those that purchased a claim from these institutions, from a supplier of goods or from a service provider also members of the second committe.
[157] Article L. 626-32 of the French Commercial Code.
[158] Article L. 626-30-2 of the French Commercial Code.
[159] Article L. 626-30-2 al 1 of the French Commercial Code.
[160] Article L. 626-12 of the French Commercial Code.
[161] Article L. 626-30-2.
[162] Article L. 626-6 of the French Commercial Code.
[163] Articles L. 626-5 al 4 and L. 627-3 of the French Commercial Code.
[164] Article L. 626-30-2 al 4 of the French Commercial Code.
[165] Article L. 626-30-2 al 3 of the French Commercial Code.
[166] Article L. 626-34 of the French Commercial Code.

Non-committee creditors, including state creditors, are consulted individually. If they cannot come to an agreement, the court cannot reduce their claims but can defer or reschedule the due date for payment[167].

Before approving the plan, the court will ensure that all creditors' interests are protected. The court can reject the restructuring plan in order to protect creditors even though it would safeguard the company's business and clear most of its debts[168].

Once approved by the court, creditors will be bound by the plan and all its terms become enforceable. Individuals or legal entities in their position as guarantors may invoke the terms of the plan. This does not concern every guarantor of the company but only those who guarantee a security (caution), are co-debtors, autonomous guarantors or have granted a personal security.[169]

1.4.2 Failure of the safeguard proceedings

The court has the power to convert safeguard proceedings into judicial reorganisation or judicial liquidation in the following circumstances[170]:

- if evidence is brought during the observation period that the company was at the opening of safeguard proceedings or is now in cessation of payments
- if it appears manifestly impossible to adopt the plan and/or the company would rapidly become insolvent if the safeguard came to an end.

2. Accelerated Financial Safeguard Proceedings (SFA)

This is a fairly new procedure aimed at implementing a restructuring plan without affecting non-financial creditors. Thus, only financial creditors (mainly banking establishments[171] and bondholders) are affected by these proceedings[172].

Trade creditors are not directly affected and their claims will be payable in accordance with their terms.

2.1 Filing

Only debtors who have opened *conciliation* proceedings since 1st March 2011 may file for an SFA.

- A debtor who wishes to invoke these proceedings must convince the court that the restructuring plan will not only address the financial difficulties it faces but will also be adopted by a qualifying majority vote of the banking establishments' committee and bondholders[173].

- Certain documents must be attached to the motion[174] and certain conditions must be fulfilled by the debtor, as follows[175] :
  - the company's accounts must be certified by a statutory auditor or prepared by an accountant; and
  - the company's turnover must equal or exceed 20 million euro per year; or
  - the company has 150 or more employees on the date of filing for the SFA.

In addition, a company may also file for an SFA if its balance sheet total is more than 25 million euro or 10 million euro if the company controls another company for which the number of employees and the turnover are respectively more than 150 employees and 20 million euro. This exception is essentially provided for holding companies that do not necessarily meet the above criteria.

2.2 During the proceedings

Many of the provisions of the French Commercial Code apply to both the SFA and the ordinary safeguard proceedings[176] but, unlike the safeguard proceedings, fast-track proceedings follow directly on from *conciliation* proceedings during which a restructuring is negotiated. On opening SFA proceedings, the court will have taken the conciliator's report into account and will look into the likelihood of the plan being adopted by the financial creditors.[177]

One of the main objectives of these proceedings is therefore to act as leverage against dissenting minority creditors by converting a *conciliation* agreement with the key financial creditors, which would require unanimous approval, into a *mandat*ory restructuring plan which does not require unanimity.

This was notably the case with the opening of the first SFA on 27 February 2013 by the Commercial Tribunal of Nanterre against the company Soflog-Telis. Here, the company was in *conciliation* proceedings but one of the five banks in a bank pool, creditor of the company, refused to sign the *conciliation* agreement. Due to the dissenting bank, the company decided to file for an SFA, to convert the *conciliation* agreement into a *mandat*ory restructuring plan forcing the dissenting bank to abide by what was accepted by the other four banks of the bank pool under *conciliation* proceedings.

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[167] Articles L. 626-5 and L. 626-6 of the French Commercial Code.
[168] Article L. 626-31 of the French Commercial Code.
[169] Article L. 626-11 of the French Commercial Code.
[170] Article L. 622-10 of the French Commercial Code.
[171] Banking establishments include all legal entities whose customary business activity is the carrying out of banking transactions or linked with such transactions such as banking and financing operations and also institutions which provide means of payment. Basically, this group mainly includes banks, financial institutions, leasing companies etc. Article L. 511-1 of the French Financial and Monetary Code.
[172] Article L. 628-1 al 3 of the French Commercial Code.
[173] Article L. 628-1 of the French Commercial Code.
[174] Article R. 628-2 of the French Commercial Code.
[175] Articles L. 628-1 al 2 referring to L. 620-1 and L. 626-9 of the French Commercial Code.
[176] Article L. 628-1 al 1 of the French Commercial Code.
[177] Article L. 628-2 of the French Commercial Code.

2.3 Outcome of these proceedings

2.3.1 Adoption of the safeguard plan

The plan will be adopted if approved by at least two thirds of the total value of the claims of all creditors who actually vote[178].

After the court's approval to proceed under an SFA, the financial creditors have one month (possibly extended by one further month) to vote on and adopt the restructuring plan (instead of six months under the standard safeguard proceedings)[179].

2.3.2 Non-adoption of the plan

If the plan is not adopted by the financial creditors within the given time limit, the court will bring the SFA to an end.[180] If the company is in cessation of payments, the court will open judicial reorganisation or liquidation proceedings.

To our knowledge, this procedure has not yet been implemented because, inter alia, of its tight time constraints.

3. Judicial Reorganisation (*redressement judiciaire*)

Judicial reorganisation is very similar to the standard safeguard proceedings except for the fact that the company needs to be in cessation of payments when filing for *redressement judiciaire*.

The purpose of these proceedings is to safeguard the company's business, maintain its activities, preserve as many jobs as possible and clear its debts.

3.1 Filing[181]

A motion to open reorganisation proceedings may be filed by the company, a creditor or the public prosecutor. The court can no longer bring its own motion to open judicial reorganisation proceedings[182].

The company is under an obligation to file a motion to open either judicial reorganisation or judicial liquidation proceedings when it is in a state of cessation of payments. The motion must be filed within 45 days of the date of cessation of payments (unless the company has already decided to enter into *conciliation* proceedings).

3.2 The Administrators

Occasionally, the court may decide that an administrator should take over the management of the company but generally[183] the company will continue to be managed by its directors although the administrator will be granted more extensive powers by the court than compared to those granted to the administrator in safeguard proceedings.

The administrator's objective will still be to assist and supervise the company, to assess the company's financial situation, come up with solutions to the company's difficulties and report back to the court[184].

3.3 During the proceedings

Judicial reorganisation provides for a stay on payments upon the opening of proceedings by the court[185] and an observation period of up to 12 months (possibly extended by a further six months)[186].

The purpose of the observation period is to:

- give the company time to implement its own reorganisation plan (the continuation plan), if it can evidence that it will be in a position to repay its creditors over a maximum period of 10 years[187]; or
- allow potential acquirers, who must be third parties, to present offers (sales plans) for the company's business[188].

3.3.1 Restructuring Continuation Plan and Sales Plans

3.3.1.1 Restructuring (Continuation) Plan

During judicial reorganisation, a restructuring plan may be drawn up by the administrator with the assistance of the directors. The plan will need the approval of the court, which will be subject to the court being satisfied that all creditors are sufficiently protected under the plan[189].

For the court to adopt the plan, the company must show that the plan will enable it to continue operating its business. If the court determines that the plan is not viable, the court can, unlike under safeguard proceedings, require a sale of business plan (the plan de cession) to be drawn up[190].

[178] Article L. 628-4 of the French Commercial Code with reference to Articles L. 626-30 and L. 626-32.
[179] Article L. 628-6 of the French Commercial Code.
[180] Article L. 628-6 of the French Commercial Code.
[181] Article L. 631-4 and L. 631-5 of the French Commercial Code.
[182] Constitutional Council Decision dated 7 December 2012, n° 2012-286.
[183] Article L. 631-9 of the French Commercial Code.
[184] Article L. 631-12 of the French Commercial Code.
[185] Articles L. 631-14 and L. 622-7 of the French Commercial Code.
[186] Articles L. 631-7 and L. 621-3 of the French Commercial Code.
[187] Articles L. 626-12 and L. 631-19 of the French Commercial Code.
[188] Article L. 631-22 of the French Commercial Code.
[189] Articles L. 631-19 and L. 626-1 to L. 626-32 of the French Commercial Code.
[190] Articles L. 631-15-II, L. 631-21-1 and L. 631-22 of the French Commercial Code.

If the company does not appear to be viable or if no offer is lodged during the observation period, the court also has the power to open judicial liquidation proceedings[191].

3.3.1.2 Offers for whole or part of the business – Sales Plan

Before making an offer, potential offerors may obtain limited information about the company from the registry of the court where the company is registered. The register will detail the debtor's assets and liabilities and also state the time within which offers may be made[192].

Offers may be made within a specific period commencing with the date the proceedings are opened until the deadline fixed by the court (or by the administrator in reorganisation proceedings)[193].

The length of this period varies and is often influenced by the debtor's financial situation and the availability of cash flow. Because the administrator is personally liable for debts incurred during his administration, he will wish to present a report to the court for review and adoption well before funds dry up. The report will analyse and evaluate all offers and recommend one of them to the court[194].

Offers made by directors of the company or their immediate relatives (in the second degree) may not be accepted[195].

The key points when presenting an offer are:

- the court can only consider and choose offers in respect of an autonomous business activity comprising assets and some or all of the corresponding employees. The court will exclude offers in respect of assets only;

- an offer, once filed, is binding until the court makes its decision in relation to the sales plans filed[196];

- an offer must set out all relevant information provided under Article L.642-2-II of the French Commercial Code including a description of the assets and activities in respect of which the offer is made, the price and payment conditions etc;

- although not encouraged by the courts, offers frequently include conditions precedent. Typical conditions may include renegotiating key contracts, confirming orders or supplies or even obtaining authorisations from governmental authorities. Offerors must notify the court by the hearing date whether the conditions have been met and, if not, whether the offer still stands;

- the administrator files all offers made with the court registry, where they are at the disposal of any interested party[197];

- once an offer has been filed, it can only be amended by improving it within two working days before the hearing[198].

If the offer is approved by the court, the payment of the purchase price, which is ratified by the court, clears most securities and charges over the assets sold[199]. This, however, will not affect security held by the creditor who financed the acquisition of the assets secured by the charge. In other words, *liability for special securities over assets guaranteeing the repayment of a loan granted to the insolvent company for the financing of the asset sold under the restructuring sales plan shall be conveyed to the purchaser. The Purchaser shall be required to pay to the creditor the instalments agreed with the creditor and that remain due as of the sale of assets under the plan*[200].

Only those employees referred to in the offer adopted by the court will be transferred with the business. The court does not have the power to impose the transfer of all employees to the buyer, although the number of employees included in an offer will be a factor taken into account by the court when deciding which offer to accept.

Employees who are not transferred to the purchaser will be made redundant.

3.3.2 Agreement with public creditors to waive their claim[201]

In judicial reorganisation proceedings, as in *conciliation* and safeguard proceedings, the debtor may come to an agreement with its public creditors, listed under Article D. 626-9 of the French Commercial Code, with regard to waiving part of their claims.

The types of claims a public creditor may waive are listed and ranked in accordance with the French Commercial Code. Their ranking is as follows:
- legal costs, price increases and fines;
- interest for late payment and moratorium interest; and
- principal sums due (but these cannot be waived in full).

The exact agreement reached with public creditors will depend on the outcome of negotiations with the company's private creditors as the French Commercial Code provides that both efforts must be coordinated.

191 Articles L. 631-15-II of the French Commercial Code.
192 Article R. 642-40 of the French Commercial Code.
193 Article L. 642-2-I of the French Commercial Code.
194 Article L. 642-5 al 1 of the French Commercial Code.
195 Article L. 642-3 of the French Commercial Code.
196 Article L. 642-2-V of the French Commercial Code.
197 Articles L. 642-2-IV and L. 642-4 of the French Commercial Code.
198 Article L. 642-2-V and Article R. 642-1 of the French Commercial Code.
199 Articles L. 642-12 of the French Commercial Code, L. 631-22 of the French Commercial Code with reference to Article L. 631-22 of the French Commercial Code.
200 Article L. 642-12 of the French Commercial Code.
201 Articles L. 626-6 and L. 613-19-I of the French Commercial Code.

The decision to waive the claims of public creditors is subject to the prior approval of the CCSF (Committee regrouping the directors of financial services and representatives of the public entities concerned).

Creditors in the public sector can also decide to waive their pre-emption rights, their ranking as holders of a charge or mortgage, to abandon these rights altogether, or even to postpone payment.

3.4 Outcome of the proceedings

3.4.1 Restructuring Continuation Plan

In principle, the rules applicable to the restructuring continuation plan are the same as those that apply to the safeguard restructuring plan (see section 1.4 above), except:

- if the plan provides for redundancies, the workers' council or the workers' representatives will need to be informed and consulted (Article L. 631-19-II of the French Commercial Code);
- if the plan provides for redundancies, the redundancies must take place within one month after the court decision adopting the plan (Article L. 631-19-II of the French Commercial Code);
- the adoption of the plan may be conditional upon the replacement or revocation of the directors at the request of the public prosecutor (Article L. 631-19-1 of the French Commercial Code);
- the court may hold that shares or any other rights giving access to share capital may not be transferred to or held by director(s) and may direct that voting rights will be held for a fixed period by a court agent (Article L. 631-19-1 of the French Commercial Code);
- the court may decide to sell such shares or other rights giving access to the share capital (Article L. 631-19-1 of the French Commercial Code);
- directors and representatives of the workers' council shall be heard or called in front of the tribunal (Article L. 631-19-1 of the French Commercial Code); and
- guarantors who may rely on the safeguard plan may not rely on the provisions of the restructuring plan (Article L. 631-20 of the French Commercial Code).

If the restructuring plan is not adopted or is not held to be viable, the court may impose a sales plan.

3.4.2 Sale of the business – Sales plan

If the offer is approved by the court, the payment of the purchase price ratified by court clears most securities and charges over the assets sold. This however will not affect the security held by the creditor who financed the acquisition of the assets secured by the charge (see section 3.3.1.2 under judicial reorganisation).

Following the sale, creditors will be repaid from the proceeds of the sale depending on their ranking, as determined by the French Commercial Code.

3.4.3 Failure of the reorganisation proceedings

If at any time during the reorganisation proceedings, the court concludes that the company is in a situation where the judicial reorganisation may no longer save the business and that, the business is no longer viable, the court will open judicial liquidation proceedings[202].

If the court does not approve the plan, the court will open judicial liquidation proceedings[203].

4. Judicial Liquidation

4.1 Filing

A company in cessation of payments is under an obligation to file a motion to open judicial liquidation proceedings if judicial reorganisation would have no prospect whatsoever of saving the business[204].

As with judicial reorganisation, the company, a creditor or the public prosecutor may open judicial liquidation, (provided that the company is not in *conciliation* proceedings)[205].

The motion must be filed within 45 days of the date of cessation of payments[206].

The documents and evidence which must be filed with the motion are the same as for judicial reorganisation, but must also show that the opening of reorganisation proceeding is "manifestly impossible"[207].

4.2 The liquidator

On the opening of judicial liquidation, the insolvency court will appoint one or more liquidators[208]. If more than one liquidator is appointed, each liquidator has the power to represent the debtor.

[202] Articles L. 631-15-II, L. 631-19 and L. 631-22 of the French Commercial Code.
[203] Article L. 631-22 of the French Commercial Code.
[204] Article L. 640-1 of the French Commercial Code.
[205] Article L. 640-5 of the French Commercial Code.
[206] Article L. 640-4 of the French Commercial Code.
[207] Article R. 640-1 of the French Commercial Code
[208] Article L. 641-1, II of the French Commercial Code.

If the judicial liquidation proceedings supersede a judicial reorganisation, the *mandataire* judiciaire will usually be appointed as liquidator. Unlike the other pre-insolvency and insolvency proceedings, the liquidator not only takes over the management of the company but also represents the creditors.

The liquidator's objective is to sell the assets of the insolvent company in the most profitable way and to pay off the creditors in order of priority out of the sales proceeds[209]. It is rare for there not to be a shortfall of assets, in which case, as set out in the answer to the questions above, de jure and de facto directors may be held liable[210].

4.3 During the proceedings

Generally, the business of the company will cease to facilitate the winding-down of the company and to prevent existing debts increasing. However, the business may continue for three months (and possibly a further three months thereafter) with a view to selling the business (in whole or in part) or if it is in the public interest or the interest of creditors for it to continue[211].

The liquidator may sell the assets in two different ways. First by selling the business in whole or in part as a going concern, but if this is not possible, by selling the company's assets on a piecemeal basis.

Two important recent updates in French insolvency law

1. The 2012 Petroplus reform

One of the most recent reforms in French insolvency law is the "Petroplus" Law adopted on 1 March 2012 (Petroplus Law) aimed at preventing the misappropriation of assets of companies in difficulty.
The Petroplus Law introduces two important measures:

- for the president of the court to authorise the seizure of assets of third parties during safeguard and reorganisation proceedings;

- on the approval of the *juge-commissaire*, for the seized assets to be sold by the court and the proceeds deposited at the *Caisse des Dépôts et des Consignations*. The proceeds will then be used to pay legal costs and to make good the breach of social and environmental obligations committed by the debtor company.

The Petroplus Law gives rise to a number of questions including what if the assets seized on the court's approval were subject to guarantees in favour of third parties and does the right of seizure conflict with property rights granted under the European Convention of Human Rights (see Question 7).

2. The liability of foreign or French parent companies as co-employer of its French subsidiary.

The French *Cour de cassation* has recently upheld case law developed by the lower courts under which parent companies, foreign or French, may be held liable for the redundancies of employees of their underperforming subsidiaries as a "co-employer".

The French *Cour de cassation* has laid down three criteria for considering whether a parent company may be a "co-employer": (i) an interest in the subsidiary (for example, an 80% holding in the subsidiary's share capital or a lack of real autonomy by the subsidiary); (ii) activities (for example, the parent and the subsidiary being involved in the same business activity); and (iii) shared management (for example, one or more directors sitting on both the parent's and the subsidiary's board).

The most debated cases are *Jungheinrich, Jungheinrich A.G, Jungheinrich Finance Holding* and *Aspocomp* in 2011, in which the Cour de cassation challenged the principle that companies are separate legal personalities. (This case law is especially relevant in the context of jurisdiction and applicable law in a cross-border scenario under Article 19 of the EC Regulation n° 44/2001 dated 22 December 2000, which provides that the "employer" can be brought before the tribunal where the employment was usually performed). Elevating the notion of "employer" to that of "co-employer" has never been referred to or upheld by the CJEU.

The case law on co-employment has continued to be applied by the *Cour de cassation*, notably in co-employment cases brought by employees against Metal Europe in 2012 and also recently against Molex, an American company, in 2013.

[209] Article L. 641-4 of the French Commercial Code.
[210] Article L. 651-2 of the French Commercial Code.
[211] Article L. 641-10 and R. 641-18 of the French Commercial Code.

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 of directors of German corporations (either 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 personally 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 and insolvency law provides for several rules relating to the contribution and the subsequent maintenance of the capital in German corporations. Furthermore, even more stringent duties, responsibilities and liabilities are imposed on directors once the assets of the company deteriorate, i.e. should the company encounter financial difficulties. 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 all times. Thus, any liability arising during the "twilight" period is mainly imposed on the directors of the corporation, who are the 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 chapter 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 and not heeding warning signs concerning the company's deteriorating financial situation. Thus, the essential duties in the "twilight" period apply to 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, financial difficulties of the company do not give rise to 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 also directors of the company). 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 (for example, the laws of the United Kingdom, which rather vaguely refer to where a director "knew or ought to have concluded that insolvent liquidation is inescapable"), German courts and literature have established explicit methods by which prerequisites indicating the start of the "twilight" period will be determined, such prerequisites being illiquidity (ie negative cashflow test), impending illiquidity, deficit balance and over-indebtedness (ie 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, for example, the English "wrongful trading" concept designed to ensure that "directors do everything possible to minimise the potential loss to creditors in anticipation of an insolvent liquidation").

Illiquidity and over-indebtedness are regarded as "absolute bankruptcy reasons" resulting in an obligation on the directors to petition for the commencement of insolvency proceedings, while impending illiquidity only gives rise to 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 if the debtor has ceased to make payments (prima facie evidence).

The German Federal Court refers to specific circumstances, according to which it will be presumed a company has ceased to make payments, such as:

- a declaration by 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 should be easily recognised by the directors.

However, as a result of an exception made by the German Federal Court, a debtor who is unable to pay less than 10% of its aggregate liabilities for a period of three weeks should not be regarded as being illiquid unless it can already be seen that the shortfall will exceed 10% in the near future.

If the shortfall amounts to 10% or more, illiquidity would be presumed unless, in exceptional circumstances, there is certainty or near certainty that the shortfall can be removed in the near future. However, to make use of the exception it must be deemed acceptable for the creditors to be paid with such a delay.

This exception is relevant to the duty to petition for the commencement of insolvency proceedings. In view of the potential criminal and civil liability, consulting an expert to clarify whether the debtor is illiquid or not is recommended as well as entrusting such expert with a liquidity balance.

1.3.2 *Impending illiquidity*

Impending illiquidity will be deemed to exist if a company is presumed to be unable to honour existing payment obligations when they become due. As mentioned above, minor shortfalls and an inability to pay less than 10% of the aggregate liabilities are not considered to be indicators of impending illiquidity.

Unlike existing illiquidity and over-indebtedness, impending illiquidity does not impose an absolute obligation on the directors to petition for the commencement of insolvency proceedings. German insolvency law has introduced impending illiquidity as an option to petition for insolvency proceedings in order to enable directors to initiate reorganisation measures, in particular the implementation of a pre-packaged reorganisation plan at an early stage of insolvency proceedings. Such a petition might be combined with a motion for a self-management order, which is derived 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 acts of execution on the debtor’s assets. However, German insolvency courts have been reluctant to make orders for self-management due to the lack of reliability of those directors who may have caused the financial crisis of the company through mismanagement in the first place.

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 a deficit balance (loss equal to one half of the company’s share capital), obliges the directors to convene a shareholders’ meeting (see 2.1.1 below), the over-indebtedness of a company is an absolute reason for immediately petitioning for insolvency proceedings.

Such over-indebtedness is not necessarily only reflected in the ordinary year end balance sheet, but it may result from a special “over-indebtedness status”. Generally, directors are obliged to monitor the financial situation carefully 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, for example, a significant loss of share capital.

In the event that an (interim) balance sheet shows over-indebtedness, the directors have to prepare an “over-indebtedness status” in order to verify whether or not the company is actually over-indebted. Such status either has to show the assets at their going concern values or their liquidation values. In a first step, the assets are evaluated based on liquidation values. Provided there is a “positive continuation prognosis”, the directors may evaluate the assets on the basis of the company continuing as 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 illiquidity of the company will not occur. Furthermore, it is not sufficient for the directors to simply accept the prognosis as correct and the results of the planning as “most probable”. German courts have always held that managers must seek the advice of independent external experts with respect to such a prognosis. These experts must be convinced, to the same extent as the management, that a positive continuation prognosis exists. In the event that an “over-indebtedness status” based on going concern values still shows a negative equity, the company must be regarded as over-indebted and this actual over-indebtedness will trigger the obligation to immediately petition for insolvency proceedings.

However, the over-indebtedness test has effectively been suspended until 31 December 2013 in cases where there is a "going-concern" for the business. This means that a company will not be regarded as over-indebted if there is a sufficient likelihood (more than 50%) that the company will stay cashflow solvent until the end of the next business year. It is unclear whether the suspension of the over-indebtedness will be extended or over-indebtedness will be removed as an insolvency reason. At present, the over-indebtedness test is to be re-instated on 1 January 2014 which means that any prognosis also has to show that there will be no over-indebtedness on 1 January 2014 (unless one argues that the extension of the suspension of the over-indebtedness is more likely than not).

1.3.4 *End of the "twilight" period*

As a result of the commencement of insolvency proceedings, the directors' right to manage and deal with assets of the company will pass to the insolvency administrator. Although the directors will still be registered with the commercial register, their power to act on behalf of the company will have practically ceased to exist. Thus, the directors can no longer be held liable for a breach of rules aimed at the protection of creditors.

In the event that the petition for the commencement of insolvency proceedings is rejected because the assets available in the estate are not 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 company's 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 deemed liquidators who are responsible for the winding up of the company without formal insolvency proceedings. This so-called "lack of assets liquidation" is not governed by any specific rules additional to the rules pertaining to the "ordinary" voluntary liquidation of companies, which are based on the assumption that the assets are sufficient to satisfy all creditors. Since the German Insolvency Code is not applicable outside formal insolvency proceedings, it is debatable whether directors are bound by the insolvent principle of equal treatment of creditors. In practice, the termination of protective measures ordered by the court, namely the prohibition on execution against the debtors' assets, will result in the lifting of the temporary restraint on execution by creditors, thereby preventing a *pari passu* distribution of assets to creditors.

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 further question 4 below).

Transactions vulnerable to being set aside	- Impending illiquidity - loss equal to one-half of the share capital	Over - indebtedness or illiquidity	Duty to petition for insolvency proceedings	Commencement of proceedings or rejection of petition due to an insufficient estate	Final liquidation (winding-up) within or without formal insolvency proceedings

Early stage of financial difficulties (up to ten years prior to petition in the event of actions intentionally harming creditors)		three week deadline to remove absolute insolvency reasons	Interim insolvency proceedings (usually up to three months)	

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 Criminal and civil liability

The German Civil Code provides that any person who violates a statute intended for the protection of others (protection statutes) is bound to compensate the injured party for any damage arising as a result. Any criminal statute aimed at the protection of property is deemed to be such a protection statute. Statutes which provide for the protection of creditors of a distressed company attach personal liability to directors, who are required to compensate for losses resulting from a breach of the protection statute. 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 is 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 its share capital. However, liability does not occur automatically with the existence of a balance sheet deficiency. Directors must constantly monitor the financial situation of the company. An action may be brought by the company seeking compensation for damages which could have been avoided by resolutions or measures which would have been adopted by a shareholders' meeting if such meeting had been convened.

2.1.2 *Duty to petition for the commencement of insolvency proceedings*

In practice, the most important civil and criminal liability of directors results from a failure to petition for the commencement of insolvency proceedings. Directors of a German company with limited liability, a German stock corporation or a German partnership which consists only of companies with limited liability have an absolute duty to petition for the commencement of insolvency proceedings without undue delay, but not later than three weeks after the occurrence of illiquidity or over-indebtedness. (See section 1.3.3 regarding the suspension of the over-indebtedness test until 1 January 2014 in case of a positive cashflow prognosis.) In addition to criminal sanctions, directors will face civil liability to compensate the company, as well as the creditors of the company, who suffer loss caused by the failure of the directors to file the petition in due time.

In addition, a shareholder is under a duty to petition for the commencement of insolvency proceedings if there are no directors or the whereabouts of all the directors is unknown. In that event, the same criminal and civil liability will arise for shareholders as for directors.

2.1.2.1 *Liability vis-à-vis the company*

The Corporate law provisions impose a duty on directors to compensate the company for any payments made after illiquidity has occurred or 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 a creditor. In calculating the compensation, one has to distinguish between creditors already having claims against the company at the time the petition had to be filed (old creditors) and creditors who have entered into business relations with the company after that time (new creditors).

Assuming that the directors had filed the petition in time, the old creditors would have received a pro-rata distribution based on the assets available at that 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 have formed part of the estate if the directors had filed the petition in time. Since the new creditors would have been refrained from entering into business relations with a company 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. For example, a bank granting an overdraft to the company has to be treated as a new creditor in the amount of the asset portfolio being increased after the time the petition was required to be filed.

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 the petition for the commencement for insolvency proceedings being denied by reason of insufficient assets available in the insolvency estate. Compensation in such cases 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 to the German Criminal Code expressly stated that directors would only be liable in the event that they failed to transfer social security contributions that had actually been deducted and withheld from wages. The new statute no longer requires such deduction and withholding. However, some higher regional courts have argued that directors cannot be held liable for a failure to transfer social security contributions where the wages have not in fact been paid to the employees. According to these court rulings, something similar to a criminal breach of trust is required which can only be deemed in the event that social security contributions are not transferred despite the corresponding wages having been paid.

The German Federal Court has reversed one of the aforementioned judgments referring expressly 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 over-indebtedness (see 1.2).

However, the German Federal Court recently ruled that a director transferring social security contributions of employees to the social security authorities or income tax to the tax authorities following illiquidity and/or over-indebtedness applying the “due care of a prudent businessman” will not incur personal liability.

Furthermore, the German Federal Court also 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 either.

Notwithstanding the above, 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, a director is required to pay compensation for the damage arising as a result of the failure to transfer social security contributions in the amount of the social security 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 by the German Criminal Code, expressly refer to the “twilight” period starting when impending illiquidity has already been established. Alternatively, such criminal statutes apply in the event of an actual over-indebtedness situation of the company, as set out above. Generally, such crimes relate to conduct which endangers creditors’ rights. Crimes frequently committed in the “twilight” period 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;
- breach 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; and
- preferential treatment of creditors by 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 conducting 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 an omission.

In contrast, MoMiG[1] creates director liability for causation of insolvency. This means that directors will be held liable for payments to the shareholders of the company by which the illiquidity and/or over-indebtedness was caused.

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 performed by the company. The director’s liability in this case was based on the director being a guarantor of obligations of the company in connection with an agreement on the provision of collateral to a supplier. The director was held 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 directors to the effect that their 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.

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1 “Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen” (or Law for the Modernisation of the German Limited Liability Company Law and the Prevention of Misuse), which came into force in Germany in November 2008[30] See paragraph 4.2.4 for an explanation of this expression.

2.2.3 *Group liability / piercing the corporate veil*

Assuming that the director is also a dominating shareholder of the company, the concept of group liability might result in an obligation on the part of the controlling shareholder to compensate any annual net loss due to the misuse of its managerial power. The German Federal Court has expressly 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, eg 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 had 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" analogous to the concept of liability in a group consisting of corporations.

However, the German Federal Court has recently issued a new judgment. The doctrine of piercing the corporate veil has been changed to a concept of inducing a subsidiary into financial assistance which actually endangers its own separate economic and/or legal existence (in other words, it may have the consequence of causing the insolvency of the subsidiary), which will result in a liability in tort towards that company. By doing so, the German Federal Court has not created a new liability but rather given a new name to the concept of piercing the corporate veil. As this misuse is identified by the damnification of the company's ability to meet its 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*).

However, this of course does not mean that the managing director is free to refuse any demand to make upstream payments. The managing director needs to undertake cash-flow planning that ensures the survival of the entity, but the shareholder is free to instruct the managing directors to limit any non-essential spending (such as cap-ex and other items) to an absolute minimum to free up liquidity for up-streaming.

The absolute outside boundary is the criminal liability of management for payment of social contributions, which means that the managing director has to ensure in his cashflow planning that sufficient funds are available for the payment of due and payable social contributions. With this exception, there appears to be no general duty of the managing director to build up liquidity reserves because the managing director is afforded broad discretion in conducting the business. However, in general a breach of the standard of a prudent business manager in handling the company's affairs may lead to civil and criminal liability of a managing director if he acts wilfully or negligently in spending cash which triggers the cash-flow insolvency of the company. In contrast, a simple management failure of the managing director will not result in any liability towards the company.

Furthermore, according to recent case law, there is no liability towards creditors, only towards the company.

2.2.4 *Breach of the capital maintenance rules*

The capital maintenance rules of the German Companies with the Limited Liability Act are aimed 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 a redemption of share capital. The repayment of a shareholder loan is not a violation of the capital maintenance rules. However, the directors must not make any payment to the shareholder if such payment will lead to the illiquidity of the company. The directors of the company are personally liable vis-à-vis the company to the extent that assets are distributed to shareholders in breach of such capital maintenance rules. This also applies to cash pool payments to affiliated companies, which comprise the assets required to maintain the registered share capital.

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 for the benefit of the tax authorities, failure to transfer such money leads to personal liability of the directors. In the event that the cashflow is not sufficient to pay the gross amount of wages, the directors are obliged 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, 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. The engineering-related directors may not be completely aware of the current financial situation of the company. Despite this, neither German corporate, commercial nor criminal law, which govern the specific duties, responsibilities and liabilities of directors, expressly attach liability pro rata to their specific involvement, nor do they allocate liability to a specific sphere of responsibilities or areas of practice. Moreover, directors are also responsible for another director's breach of duties, so that in practice each director has to use due diligence not only in his own affairs but to ensure that the other directors also meet the requirements to the same degree.

However, these principles are not consistently applied, so that a defence like the allocation of spheres of responsibility 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 of the relevant financial matters.

The following show whether liability will be attached according to the breach of specific duties by the respective director or whether any director of the management board will face liability irrespective of his involvement.

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 counterparties, ie as public authorities or creditors dealing with an already illiquid company, that defence is not available.

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 of shareholders in case of a company without management in place
Liability vis-à-vis social security authorities	Liability is allocated to directors who actually fail to transfer the social security 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 causing insolvency proceedings	Joint liability
Breach of agreement	Joint liability
Piercing of corporate veil	Joint liability Liability of shareholders as well
Breach of the 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; and (iii) the other directors properly supervised the responsible director

2.5.2 *No default in case of qualified external consulting*

According to recent case law, a director will not be liable for payments made after the illiquidity of the company where there has been qualified external consulting. This means if the director consulted an external expert, informed him about all the circumstances relevant to the evaluation and did not petition for the commencement of insolvency proceedings in accordance with the expert's evaluation and his own validity check, that he cannot be held liable.

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2.5.3 *Actual involvement*

As set out above, directors, irrespective of their actual involvement in financial matters and their sphere of responsibilities, must be generally aware of the company's current financial situation at all times. The German Federal Court has held that the defence of lack of knowledge of the company's insolvency situation will only be available if such lack of knowledge is not caused by the directors' negligence in exercising their observational duties and instituting financial control systems.

2.5.4 *Return to solvency*

The financial crisis of any distressed company need not be permanent 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 breach of duties. In the event of a sustainable financial recovery, enabling the company to fully satisfy any claims of creditors, it is unlikely that any criminal prosecution or civil action based on a past insolvency situation would be commenced. One exemption is with respect to the breach of capital maintenance rules. The German Federal Court recently held that a return to solvency will not cure the breach and any liability. Similarly, criminal proceedings 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

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 under 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, the liability of other persons involved with distressed companies can be based upon breaches of statutes of German law as set out above if they were accomplices to or participants in the breach. 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 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 required to file their appointment with the commercial register of the competent local court. De facto directors may, however, actually govern and control the management of the company and, therefore, may be deemed to be acting in a directorial capacity. The German Federal Court is not inclined 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.

To establish liability as a de facto director: (i) the de facto director must be regarded as having conducted the business of the company decisively; (ii) with his own actions vis-à-vis the outside world/third parties.

3.2.2 *Former directors*

Directors' liability is based on conduct exercised during the period of their directorship, so that even former directors may face liabilities regarding their directorship. The German Insolvency Code also provides 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, owe the same duties of information and cooperation towards the insolvency administrator as persons who are still directors 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, eg by way of exercising typical management duties, run the risk of being treated as de facto directors according to the principles set out above.

Furthermore, Supervisory Board members may face liability vis-à-vis the company if they fail to exercise the due care of a prudent businessman during the "twilight" period. Supervisory Board members may also be liable for any delay in petitioning for the commencement of insolvency proceedings. In this respect, the following will be regarded as a breach of duties:

- non-compliance with the more stringent supervising requirements in the event 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 the event 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. First, 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? Second, can an unconnected third party rely on security granted 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 a time when the company is likely to become subject to a formal insolvency proceeding might encourage directors not to comply with their duty to petition for the commencement of insolvency proceedings. This might be regarded as participation by the lender in the crime of delaying the petition for bankruptcy proceedings committed by the directors. Therefore the lender has to act with the intention of improving his position to the disadvantage of third-party creditors of the distressed company. Such intention to harm third-party creditors will be presumed in any case where the lender thinks that damage to the other creditors is possible and accepts the possibility of such damage. If the lender fails to properly verify the viability of the distressed company's restructuring plans (or disregards serious doubts about such restructuring plans), the intent (dolus eventualis) to damage creditors may be presumed.

With respect to the 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 the 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 would result in a 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 furnish proof that the company is expected to be 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. One way of providing the necessary proof is by obtaining independent third-party advice in this respect. As a result of various decided cases, market practice has developed whereby the debtor's plans are reviewed for the lenders by an independent third party in a so-called restructuring opinion. However, the lenders themselves must be convinced as to the validity of the restructuring plan.

Furthermore, 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, ie a positive continuation prognosis (positive Fortführunsprognose) for the company's business at least up to the end of the following fiscal year. This restructuring plan should be reviewed by an independent expert as to its plausibility (also as regards the assumptions made by the management of the debtor in the restructuring plan). Following that review, the expert should confirm in the restructuring report to the lenders that there is a going concern forecast, that is, a positive continuation forecast for the debtor's business at least up to the end of the following fiscal year. In particular, the experts should express the opinion that the financial position of the distressed company is, on the balance of probabilities, likely to be strong enough for the distressed company to continue its business as a going concern up to the end of the following fiscal year.

Accordingly, if lenders fail to properly observe these criteria they could be held liable under the deepening insolvency doctrine.

If lenders are held liable under the concept of deepening insolvency their loan facility, in so far as it is related to new money, would be held invalid as a matter of German law. Further, the new money lenders could be held liable by any new creditors of the debtor for the full amount of the loss suffered by those creditors in the insolvency. The new lenders could also be held liable by any old creditors but only to the extent that the payout that such creditors receive in the insolvency is less than it would have been if the debtor had filed for insolvency at the time the second lien lenders provided the funding.

Furthermore, there are instances where short-term liquidity needs arise and no final restructuring plan and/or report is yet available. In that case, there can be a short extension of facilities or a granting of new money in order to avoid an illiquidity of the debtor during the time required for the plan and/or report to be formulated and finalised. New loans granted during such period which bridge the liquidity situation until the finalisation of the restructuring plan/report will not be regarded as delaying the insolvency.

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, those 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

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 Transactions potentially subject to an action to set aside

4.1.1 *General rule / heads of challenge*

Transactions to the detriment of creditors effected prior to the commencement of insolvency proceedings might be subject to an action to set aside. Transactions will be deemed as detrimental if 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 counterparty 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; and

(vi) redemption of shareholder loans,

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 counterparty dealing with the company during the "twilight" period, it is decisive whether:

(i) the counterparty 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 of circumstances which compel the conclusion with respect to the illiquidity or the petition for commencement of insolvency proceedings;

(iv) the counterparties are persons related to the distressed company and, therefore, will be deemed as having such knowledge;

(v) the counterparty had knowledge of circumstances which compel the conclusion that the transaction was detrimental to the insolvency creditors;

(vi) the counterparty had knowledge of the intent of the distressed company to harm its creditors (such knowledge will be presumed if the counterparty had knowledge of an impending illiquidity and of the fact that the transaction was harmful to creditors); and

(vii) the counterparty 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 even if formal insolvency proceedings are not commenced following the "twilight" period. Such voidability of transactions is governed in separate statutes (the Avoidance Act (Anfechtungsgesetz)). Any claim must be filed by a creditor and not by an insolvency administrator. If execution against the assets of the debtor will not result in 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 cannot refer to the petition for the commencement of insolvency proceedings. Therefore, 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 is decisive.

4.2 Defences

4.2.1 *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 the transaction was also of benefit to the company's creditors. In determining whether or not any transaction was to the benefit of creditors, only the assets of the insolvency estate available for distribution to creditors will be considered. If any transaction entered into during 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 subordinated creditor), the transaction will not be regarded as of benefit to 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) that the creditor had knowledge that the transaction was detrimental to the insolvency creditors, or knew of circumstances that compel the conclusion in this respect.

Any lack of knowledge of the 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 entered into 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 time the transaction was entered into.

4.2.4 *Other defences*

Transactions by the debtor with the intent of harming its creditors entered into within ten years prior to the petition for the commencement of insolvency proceedings can be challenged. Therefore, a lack of intent 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 intent 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 intent to prefer is limited.

QUESTION 5

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 damage due to a breach of duties irrespective of whether they are suppliers, lenders, shareholders or third parties dealing with the company. In addition, tax authorities and social security authorities may 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 cannot reasonably claim compensation from the directors since their civil liability is normally based upon: (i) a breach of the 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, shareholders are only liable in the amount of the received payments to which they were not entitled.

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 creditors who have suffered jointly and severally as a result of a reduction in the insolvency estate (joint damages) may be submitted only by the insolvency administrator during the insolvency proceedings. As outlined above (see 2.1.2.2 above), in the event of a delay in the presentation of the petition for commencement of insolvency proceedings, such joint damages will be suffered by the old creditors since the diminution in the insolvency estate will lead to a reduction in the pro rata distribution of the assets of the insolvency estate. In contrast, the 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 by the insolvency administrator*

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, 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 those which 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 a company with limited liability or a stock corporation) will be dissolved upon the commencement of insolvency proceedings (unless the shareholders resolve to continue the company following a successful implementation of a reorganisation plan), the insolvency administrator will not be regarded as an office holder for the company, but will represent the insolvency estate comprising the assets belonging to the company at the time of the commencement of the proceedings as well as those acquired during the course of the insolvency proceedings.

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 Introduction

A German civil court will order directors to pay compensation to the party who suffered the damage 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, compensation might be claimed either by the company (ie the insolvency estate represented by the insolvency administrator as office holder (see above)), or by a creditor, shareholder, public authority or any 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 that of 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	Compensation payable by directors to the company (civil liability) Up to three years' imprisonment or fine
Duty to petition for the commencement of insolvency proceedings	Compensation payable to new creditors or to the insolvency administrator (joint damage) Up to three years' imprisonment or fine
Liability vis-à-vis social security authorities	Compensation payable to authorities Up to five years' imprisonment or fine
Fraudulent trading / crimes pertaining to insolvency	Compensation payable to crime victims Up to five years' imprisonment or fine Disqualification from acting as director for five years
Liability arising from the causation of insolvency proceedings	Compensation payable to company
Breach of agreement providing security	Compensation payable to creditor who was to be secured
Group liability / piercing the corporate veil	Compensation payable to company
Breach of the capital maintenance rules	Compensation payable to company
Liability vis-à-vis tax authorities	Compensation payable to authorities

QUESTION 7

7. Duty to co-operate

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?

The German Insolvency Code imposes extensive duties of information and cooperation on the debtor company in favour of the insolvency administrator. If the debtor is a corporation, the duties apply to all members of the executive or supervisory boards. Additionally, other parties involved in the insolvency proceedings, such as creditors in possession of security or other parties to whom assets of the debtor were transferred by way of a potential voidable transaction, can be compelled to cooperate with the insolvency administrator.

Any resignation of directors coincidental with the commencement of insolvency proceedings will not result in a discharge of these duties to the insolvency court, the insolvency administrator or the creditors' committee. Information and cooperation duties apply to any relevant person who left not earlier than two years prior to the commencement of the insolvency proceedings.

As to the level of cooperation, the German Insolvency Code states that the directors shall assist the insolvency administrator in the performance of his duties and shall make themselves available at the order of the court for this purpose. Any duty may be enforced by the insolvency court, ordering any director 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 any director into custody if he refuses to comply with his information and cooperation duties.

The German Insolvency Code does not recognise the defence of privilege against self-incrimination with regard to the aforementioned information and cooperation duties. Directors are obliged to disclose facts even if they are likely to result in criminal prosecution or administrative judicial remedies. However, the use of any 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) five years from when the crime is committed b) five years from the origination of the claim (does not depend on the shareholders' knowledge)
Duty to petition for the commencement of insolvency proceedings	a) five years from when the duty of directors to petition for insolvency proceedings ceased to exist (eg if over-indebtedness has been removed) b) claims of the company: five years from the origination of the claim (does not depend on the shareholders' knowledge) claims of creditors: three years from when the injured party has knowledge of injury five 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) five years from when the liability to contribution ceased to exist b) three years from when the injured party has knowledge of injury
Fraud / crimes pertaining to insolvency	a) five years from when the duty of directors to petition for insolvency proceedings ceased to exist (example given if over-indebtedness has been removed) b) three years from when the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period
Liability arising from the causation of insolvency proceedings	a) directors and shareholders: three years from when the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period (civil liability) b) directors: according to MoMiG five years from the origination of the claim (does not depend on the shareholders'knowledge)
Breach of agreement	three years, unless special limitation periods apply
Piercing the corporate veil	three years from the origination of the claim and the obligee's awareness of circumstances giving rise to the claim and the identity of the obligor
Breach of the capital maintenance rules	five years from the time of the breach
Liability vis-à-vis tax authorities	four years regarding tax assessment
Disqualification of directors	Disqualified as managing director for five 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 may be subject to appeal unless the civil court of first instance orders compensation which does not exceed €600.

As outlined above, any disqualification of directors resulting from a sentence or side sanctions ordered by a criminal court may 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 conducted 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 is emerging in the German insurance market. It has been introduced by US and British insurance companies which have substantial experience in their respective foreign markets motivated by an urgent need of directors to protect themselves against personal liability which may arise in connection with the aforementioned actions. This has been further encouraged by a more robust attitude on the part of insolvency creditors seeking to recover their losses from directors. It is expected that the German courts will strengthen their demands as to compliance by directors with their duties, namely their duty to petition for the commencement of insolvency proceedings and to be aware of the financial situation of the company. On the other hand, premature petitioning is not advisable because this could be regarded as a general breach of the managing duties of directors and, therefore, could lead to compensation claims by the company.

Following the approach of probably all German insurance companies, the coverage of risk does not include intentional or "consciously" negligent misconduct of directors.

Furthermore, according to common practice in the US, insurance companies used by 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, (that is, 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 have resulted 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 mere negligent breach of duties. However, even this protection may prove not to be effective bearing in mind that, in practice, the dividing line between "mere" negligence on the one hand, and "conscious" negligence or "contingent" intention on the other, is difficult to determine.

Directors may already act in a "consciously" negligent way if they consider the existence of a financial crisis as "probable". As far as insolvency-related crimes resulting in 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 compensation claimed against the directors was payable out of the assets of the company, such as wage taxes or social security contributions.

The German Federal Court has held that a company with limited liability may indemnify directors of a company with limited liability with respect to claims of third parties arising from the implementation of instructions of shareholders urging directors to breach their duties. Apart from this, general indemnification by the company on a contractual basis is only permissible if it does 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 their 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

Continued demand for funds in the “twilight” period, in particular fresh money to avoid illiquidity and/or over-indebtedness, may compel directors to seek further funding either by shareholders or third parties, ie lenders or suppliers.

As mentioned above, directors will 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 supply goods without the directors having any prospect of being able to repay the loans or pay for the goods. Moreover, directors exploiting their own personal trust rather than acting as representatives of the distressed company when incurring further credit may become personally liable in the event that the security provided cannot be successfully realised by the creditor due to an action to set aside or for practical reasons.

11.2 Counterparty risks

Shareholders providing loans can only claim redemption of the loan in insolvency proceedings as subordinate insolvency creditors, ie following the complete satisfaction of the ordinary non-subordinated insolvency creditors. Any redemption of shareholder loans might be set aside by the insolvency administrator if the redemption was effected in the year prior to the petition for the commencement of insolvency proceedings or following such petition. Security provided for the redemption of a shareholder loan might even be set aside if it was effected in the 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

New legislation

On 12 July 2012, the Hong Kong legislature passed a Companies Bill (the New CO). This is a very significant piece of new legislation, which will affect a number of the issues considered in this chapter. It is currently anticipated by the legislature that the New CO will be implemented and become effective in 2014.

Implementation of the New CO will not be a simple exercise. It will require over ten supporting regulations and the Companies Registrar will need to review its procedures and also enhance its information systems. Accordingly, it is possible that the legislature's anticipated timetable will not be met.

One of the key points to note in the context of this chapter is that the New CO does not overhaul or supplement the existing insolvency procedures. Instead those are to be retained in the existing CO, which is to be pared back to deal primarily with winding-up procedures and will be renamed the Companies (Winding Up and Miscellaneous Provisions) Ordinance.

A number of changes to Hong Kong's insolvency laws have been under review for some time. This is likely to lead to implementation of a procedure to be known as provisional supervision and also the introduction of the concept of wrongful trading. Earlier draft legislation was abandoned due to differences of view over the treatment of employee claims in a provisional supervision, so the introduction of the less controversial wrongful trading provisions has also been delayed. This legislation is now anticipated within the next year or two, but the precise timing remains uncertain.

It is not practical to consider in full in this chapter the implications of this new and anticipated legislation. Accordingly, this chapter focuses on the existing legal position and references to the Companies Ordinance or CO should be read as references to the existing (unamended) Companies Ordinance. However, where it is known or expected that new legislation will fundamentally change certain key concepts, this has been highlighted.

In light of the changing legislative position, it will be particularly important to take appropriate advice to confirm that the law remains as described in this chapter.

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[1]. 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 either at the time of, or as a result of, the transaction. 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).[2]

[1] This chapter refers to a number of post 1997 English cases. Technically these cases are not binding precedents in Hong Kong, but the Hong Kong Courts have often found relevant English decisions to be highly persuasive.
[2] Section 184 Companies Ordinance (Cap 32).

A company is insolvent when it is unable to pay its debts. There are two main tests used to establish whether a company is able to pay its debts.[3] 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[4].

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 the directors of an insolvent company exercise their duties they must have regard primarily to the interests of the creditors 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) (sections 266 and 266B CO (Cap 32)) (CO);

(b) floating charges - 12 months (section 267 CO);

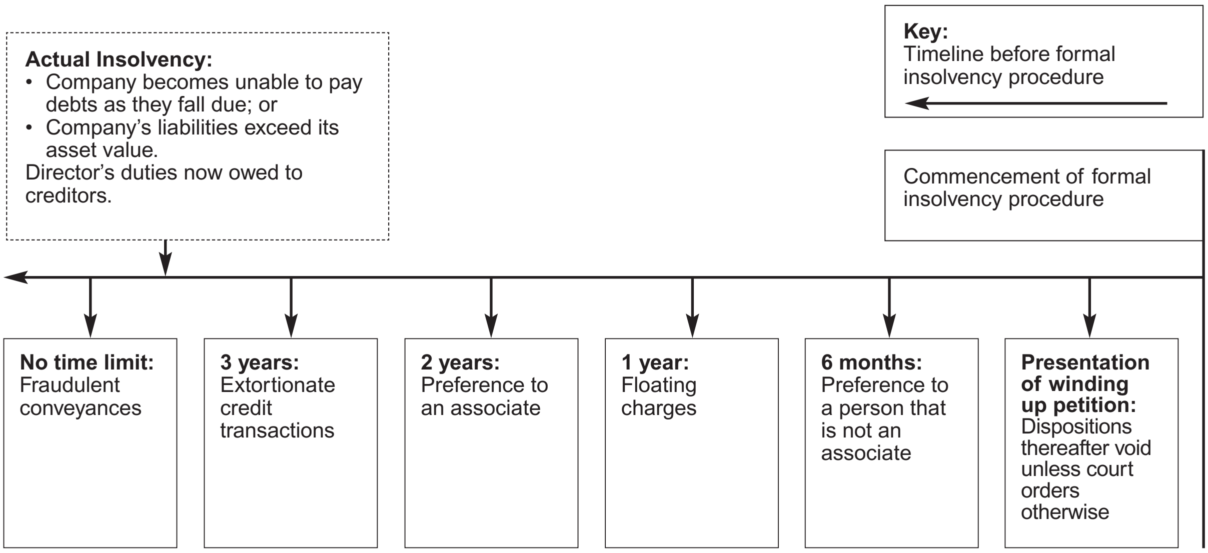
(c) extortionate credit transactions - 3 years (section 264B CO);

(d) disposition after presentation of petition - from date of presentation (section 182 CO); and

(e) fraudulent conveyances - no time limit (section 60 Conveyancing and Property Ordinance).

Under the current law, transactions at an undervalue are only vulnerable in personal bankruptcy.

We set out below a "time line" summarising the statutory provisions mentioned above.



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?;

3 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.

4 The distinction between the balance sheet test and the cash-flow test may have been rather blurred by the English Court of Appeal's decision in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007 3BL plc & Others* [2011] EWCA Civ 227. The Court stated that the balance sheet test is not a pure 'mechanical' test whereby if liabilities exceed assets as shown on the company's balance sheet, it will be deemed insolvent. Rather, the question is whether the shortfall in assets relative to liabilities is indicative of an actual inability to pay future and contingent debts as they fall due or if the company has reached "the point of no return".

(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 acts for which a director may be held personally liable during the "twilight period" although there is currently no equivalent to the English law provision for wrongful trading (although see new legislation section at the beginning of this chapter).

2.1.2 Proceedings against directors (and other persons who may be caught by these provisions) based on the statutory provisions described in 2.2 to 2.7 below are uncommon, with the exception of proceedings against officers for failing to keep proper accounts.

2.2 Fraudulent trading[5]

(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,[6] actual dishonesty is an essential element to establish liability for fraudulent trading under Hong Kong law. As is the case in other jurisdictions with provisions similar to section 275 CO, it is relatively rare for persons to be found liable for fraudulent trading due to the difficulty of proving dishonesty.

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 liquidation for civil liability to be incurred (section 275(1) CO) whereas criminal liability may be incurred irrespective of whether the company is in liquidation or not (section 275(3) CO);

(ii) there must be actual intention to defraud creditors or to achieve a particular fraudulent purpose whilst running the business[7] 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)[8] whereas for criminal liability proof 'beyond reasonable doubt' is required; and

(iv) any 'knowing party' to the dishonest running of the business 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 or recklessly).[9]

(b) (i) Liability may be civil and/or criminal depending on whether the company is in 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.[10] The court has a wide discretion in this regard and 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.

(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 Fraud by officers of companies which have gone into liquidation[11]

(a) It is an offence for an officer[12] of a company:

(i) to make or cause to be made any gift, or transfer of or charge on or to have caused or connived in the levying of any execution against the property of the company; 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 judgment or order for payment of money obtained against the company,

in each case, with the intent to defraud creditors.

(b) (i) Liability under this provision is criminal.

[5] Section 275 CO.
[6] Section 213 IA 1986.
[7] This includes a single act and it need not be established that a series of acts were conducted.
[8] *Aktieselskabat Dansk Skibsfinansiering v Wheelock Marden and Co Ltd* [2000] HKCFA 31.
[9] *Re Bank of Credit and Commerce International SA (No.2), Banque Arabe et Internationale D'Investissement SA v Morris* [2000] All ER (D) 1437).
[10] This is true even where the claim is brought by a creditor or contributory. The claim is not limited to the loss of the relevant creditor or contributory but is instead limited by the loss of the company. See *Kong Mou Holdings Ltd v Cheung Sheun Lung and Others* [2004] HKCFI 192.
[11] Section 273 CO.
[12] Officer includes the directors, managers and secretary of the company (see 3.3 below).

(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 wrong doing 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 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 judgment or order.

(v) The main defence is absence of intent to defraud creditors.

2.4 Offences by officers of companies in liquidation[13]

Fraud in anticipation of winding-up[14]

(a) It is an offence for any officer[15] or shadow director[16] 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 wrong doing 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; and

(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.[17]

Misconduct in the course of winding-up[18]

(a) It is an offence for any officer[19] or a shadow director[20] of the company, whether past or present.

(i) not, to the best of his knowledge and belief, to fully and truly disclose 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.

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[13] Section 271 CO.
[14] Sections 271(1)(d), (e) and (o) CO.
[15] Officer includes the directors, managers and secretary of the company (see 3.3 below).
[16] 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).
[17] Section 358 CO. The court rarely makes such orders.
[18] Sections 271(1)(a), (b), (c), (f) (g) (h) and (l) CO.
[19] Officer includes the directors, managers and secretary of the company (see 3.3 below).
[20] 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).

(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 wrong doing 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.

(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.[21]

Falsification of company's books[22]

(a) It is an offence for any officer[23] or a shadow director[24] 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) 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; or

(iii) 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.

(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 wrong doing 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;

(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.[25]

False representation to creditors[26]

(a) It is an offence for any officer[27] or shadow director[28] 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 for this offence 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 wrong doing 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.

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21 Section 358 CO. The court rarely makes such orders.
22 Section 271(1)(i), (j) and (k) 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).
25 Section 358 CO. The court rarely makes such orders.
26 Section 271(1)(p) 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).

2.5 Liability where proper accounts are not kept[29]

(a) It is an offence for an officer[30] or shadow director of a company who knowingly and wilfully authorises or permits the failure[31] 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 and statements of annual stocktakings).

(b) (i) Liability for this offence is criminal.

(ii) A person who is found 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 wrong doing as a punitive measure, not as a means of compensating the company.

(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.

(c) Under the New CO, the category of persons who can be liable for offences committed by officers and shadow directors has been widened. The New CO introduces a concept of responsible person who will be liable for an offence if the person authorises or permits, or participates in, the contravention or failure. A responsible person includes officers or shadow directors of a company or non-Hong Kong company as well as officers or shadow directors of a company that is an officer or shadow director of the company or non-Hong Kong company.

2.6 Penalty for falsification of books[32]

(a) It is an offence for any officer[33] 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 wrong doing 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[34]

(a) A past or present officer[35] 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 designed 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, having regard to proportionality.

(iii) The time within which the relevant act must have been committed is limited only by the Limitation Ordinance.[36]

(iv) 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.[37]

2.8 General fiduciary duties owed to a company

(a) The duties of a director are those applying to all fiduciaries. A director must act 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 interests of the members. 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 a proper purpose;

[29] 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).
[30] Officer includes the directors, managers and secretary of the company (see 3.3 below).
[31] Section 351(2) CO.
[32] Section 272 CO.
[33] Officer includes the directors, managers and secretary of the company (see 3.3 below).
[34] Section 276 CO.
[35] Officer includes directors, managers and secretary of the company (see 3.3 below).
[36] Limitation Ordinance (Cap 347).
[37] Section 358 CO.

(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.[38]

(iv) The time within which action must be taken against a director is limited only by the Limitation Ordinance.[39]

(v) Any director may be relieved by the court from liability for a breach of fiduciary duty in whole or in part on such terms as the court thinks fit 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.[40]

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

(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.[41]

(iv) The time within which action must be taken against a director is limited only by the Limitation Ordinance.[42]

(v) Any director may be relieved by the court from liability for a breach of fiduciary duty in whole or in part on such terms as the court thinks fit 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.[43]

(c) One of the important changes to be made by the New CO is the introduction of a statutory duty for directors to exercise reasonable care, skill and diligence when carrying out their duties. The test for what would constitute reasonable care, skill and diligence has both subjective and objective components and is similar to the common law duties set out above. In performing their duties, directors are required to apply the general knowledge, skill and experience that would be reasonably expected by a director in the same position in addition to the general knowledge, skill and experience of the particular director. Following implementation of the New CO, this new statutory duty will replace the common law duties currently applicable to directors.

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.[44]

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(1) CO prohibits 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 a non-executive director will 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, 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 director 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 director 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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38 Civil Liability (Contribution) Ordinance (Cap. 377).
39 Limitation Ordinance (Cap 347).
40 Section 358 CO.
41 Civil Liability (Contribution) Ordinance (Cap. 377).
42 Limitation Ordinance (Cap 347).
43 Section 358 CO.
44 *Equitable Life Assurance Society v Bowley* [2003] B.C.C. 829.

2.11 Liability of directors to disqualification for acts in the twilight zone[45]

2.11.1 The provisions in the CO providing for disqualification of directors are based upon the Company Directors Disqualification Act 1986 (CDDA).[46] 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. Under section 168C CO, "company" is widely defined to include unregistered companies, or registered companies, whether they may be incorporated in or outside of Hong Kong.

2.11.2 There is no definitive 'twilight zone' for directors in respect of 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.[47]

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.[48]

Grounds for disqualification

2.11.5 There are six grounds for disqualification. The three grounds which can apply to a company outside of insolvency are:

(i) where any person has persistently breached requirements of the CO for the filing of any return, account or other delivery to the Registrar;[49]

(ii) where a person is convicted of an indictable offence in connection with the promotion, formation, management or liquidation of the company or in connection with the receivership or management of a company's property or any other indictable offence which involves fraud or dishonesty;[50] and

(iii) where it appears to the Financial Secretary from a report made to him that it is expedient in the public interest that a disqualification order should be made against a person who is or has been a director or shadow director of any company, he has applied to the court and the court is satisfied that the person's conduct makes him unfit to be concerned in the management of a company.

The three remaining grounds require that the company is insolvent at the time of the relevant conduct or subsequently becomes insolvent. These grounds are:

(iv) where, in the course of a winding up of a company, it appears that a person is guilty of fraudulent trading (criminal liability) or otherwise guilty while being an officer[51] or shadow director[52] of the company of any fraud or breach of duty[53];[54]

(v) where a court is satisfied that the conduct of a past or present director[55] or shadow director[56] of an insolvent company, makes him unfit to be concerned in the management of a company[57] (the court has no discretion as to whether the director is disqualified in the event that unfitness is proved);[58] and

(vi) where a director is found liable for fraudulent trading (even if no application for a disqualification order was made).[59]

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 CO. 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.[60] The list is not exclusive and may be modified by order of the Financial Secretary. 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. Except with the leave of the court, an action for disqualification relying on the ground of unfitness must be made within four years of the date of commencement of winding-up or within four years from the date on which a receiver's appointment is terminated.[61]

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[45] Part IVA CO.
[46] See 2.15 of the England Chapter.
[47] Section 168L CO.
[48] Section 168M CO.
[49] Section 168F CO.
[50] Section 168E CO. Examples include section 273 and section 276 of CO.
[51] Officer includes directors, managers and secretary of the company (see 3.3 below).
[52] 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).
[53] 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.
[54] Section 168G CO.
[55] 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).
[56] 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).
[57] Section 168H CO.
[58] Section 168H(1) CO.
[59] Section 168L CO.
[60] Section 266B CO (see 4.3.1 below).
[61] Section 168I(2) CO.

Length of disqualification

2.11.7 The period of disqualification is in the court's discretion subject to the maximum period being generally 15 years (and the court having jurisdiction where disqualification arises on conviction of an indictable offence).[62] 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:[63]

(i) 1 - 5 years for cases which are relatively not very serious;.[64]

(ii) 6 - 10 years for serious cases which do not merit the top bracket;[65] and

(iii) 10 -15 years for particularly serious cases, including where a director is disqualified for a second time.

2.11.8 Enforcement of disqualification orders in Hong Kong is primarily the 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 section 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 section 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 section 168G, may also be brought by the Financial Secretary, the liquidator or any past or present member or creditor of any company against which that person has committed an offence or default; and

(iii) an application for disqualification relying on one of the two 'unfitness' grounds[66] may be brought by either the Official Receiver or the Financial Secretary as long as it is considered to be in the public interest.[67] 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 with a view to determining whether there is a case for disqualification proceedings on the ground of unfitness.

Duty to co-operate

2.11.9 Liquidators have the power under the CO to require directors to provide certain information and deliver up the company's property to them and the court may penalise directors for failing to co-operate (see section 7 below for more detail).

2.11.10 Disqualification proceedings on the grounds of unfitness under section 168H must be brought within four years of the date 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. Provided 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, an order can be made against a foreign national or resident abroad in relation to a Hong Kong incorporated company or registered overseas company or any unregistered company incorporated outside Hong Kong and can be based on acts committed abroad.

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?

62 Section 168E(3) CO.
63 *Re Observers Travel Enterprise Co Ltd (In Liquidation)* [2001] HKCFI 78 applying *Re Sevenoaks Stationers (Retail) Limited* (1991) CoA.
64 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* [2002] 3 HKLRD 805). A number of cases in Hong Kong have referred (applying Re *Sevenoaks Stationers (Retail) Limited* (1991) (CoA) to a minimum period of 2 years. However, this is not correct and subsequent cases have shown that disqualification periods of less than 2 years can be ordered.
65 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.
66 i.e. under 168H in relation to an insolvent company or under 168J following investigation.
67 Section 168I(1) CO.

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 period may also be held liable, as can 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 period which are vulnerable to challenge, such as unfair preferences. Liability may also arise where a third party has knowledge of a breach of duty of 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. 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, should still be 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 adopted the concept of "shadow directors" to cover those persons who are not directors or do not have any formal role in the decision-making process of a company but are nevertheless controlling the company through its directors from behind the scenes.

De facto directors

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 the CO as "any person occupying the position of director by whatever name called"[68] and therefore includes those persons who are called by other names but participate in decisions of the type made by directors. The recent English cases of Gemma Ltd v Davies [2008] BCC 812 and Holland v Commissioners for Her Majesty's Revenue and Customs [2010] UKSC 51 (the Supreme Court) consider what constitutes a *de facto* director and may well guide the Hong Kong approach. The most relevant tests to consider are therefore likely to be whether the person was the sole person directing the affairs of the company (or acting with others equally lacking in a valid appointment) or if there were others who were true directors, whether he was acting on an equal footing with the others in directing its affairs; whether there was a holding out by the company of the individual as a director and whether the individual used the title and, taking all the circumstances into account, whether the individual was part of the "corporate governing structure". In particular, the Holland case also considered when a individual (sole) director of a corporate director will be deemed a *de facto* director of the company in respect of which it is a corporate director.

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 directors or a majority of the directors of the company act on advice given by him in a professional capacity".[69]

3.2.6 There have been few cases in Hong Kong in which the meaning of "shadow director" has been considered. 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 expressly been considered by the Hong Kong courts although the approach taken in interpreting the relevant provision has been considered and followed.[70]

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. This is a defined term in the CO meaning a director[71], 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.[72] 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.

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68 Section 2(1) CO.
69 Sections 2(1) and (2) CO.
70 *Fred Lee v Lee Yuk Man* [2007] HKCFI.
71 This includes de facto directors by virtue of the definition of director (see 3.2.2).
72 Section 2(1) CO.

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.[73]

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[74].

(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.[75]

(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.[76] 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.[77]

(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 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 belonging to a company knowing it to have been 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.[78]

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	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. A 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 3.4(v) above)	Same as for director
Liability where proper accounts not kept (s.274 CO)	Officers and shadow directors[79] (who knowingly and wilfully authorise or permit the default) of the company at the time of the default	Same as for director Same as for director
Falsification of books (s.272 CO)	Officers or contributories of the company at the time of the offence	Same as for director
Misfeasance	Any past or present officer, 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 (ss.266 and 266B CO)	Creditor, surety and guarantor	The court has discretion to restore the position of the parties 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

73 Section 276 CO.
74 Sections 266 and 266B CO.
75 Section 182 CO.
76 Section 275 CO.
77 This is the common law position under English Law (see *BCCI v Christopher Morris* [2000] All ER (D) 1437).
78 Section 271(2) CO.
79 Section 351(2) CO defines the reference to 'defaulting officer'.

3.6 New Companies Ordinance

The New CO will provide the Hong Kong courts with a wider range of remedies that may affect third parties or contractual counterparties in certain circumstances than exist under the current CO.

If on petition of a member, the Court considers that a company's affairs or an actual or proposed act or omission of the company has been conducted in a manner prejudicial to the members generally or one or more members, then the Court can make any order it sees fit to give relief. The legislation expressly allows the Court to order any person to pay damages as the Court sees fit.

If, in relation to a company, a person engages in conduct that constitutes a contravention of the New CO or the existing CO or a breach of any fiduciary duty owed to the company (or other director's duty owed to the company), then the court may order remedies including damages and a declaration that any contract is void or voidable.

Both of these concepts exist under the current CO but the New CO appears to widen the range of remedies available.

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

The provisions under Hong Kong law allowing 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.[80] This considerably 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 retrospectively, resulting in the counterparty losing the benefit of the transaction, 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; and

(h) transactions comprising an unregistered charge.

4.3 Unfair preference

4.3.1 An unfair preference occurs when an act of the company, whilst 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 had the company 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 of the parties to what it would have been if the company had not entered into the relevant transaction.[81]

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;[82]

(2) the transaction must take place during the 'relevant' period which ends with the commencement of the winding-up of the company.[83] The applicable period depends on the identity of the preferred person and is:

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[80] The equivalent English law provisions are sections 238 and 423 IA 1986.

[81] 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 Ordinance by reference which has left significant gaps in the definition of a corporate entity's associate (see 4.3.3 below).

[82] Section 50(1) Bankruptcy Ordinance (Cap 6).

[83] The commencement of the winding-up of the company for the purpose of this section is the day on which the relevant petition to wind-up the company was presented or, in the case of a voluntary winding-up, the date of the relevant resolution.

(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'[84] at the time of or becomes insolvent as a result of the transaction.

4.3.3 There is no satisfactory definition of an 'associate' of a company,[85] 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). There are some categories of associate as defined in the Bankruptcy Ordinances which obviously have no application to a company, such as spouses or relatives. The persons falling within the definition of 'associate' which are relevant to a 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 where 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.[86]

4.3.4 It should be noted that those persons not falling within the definition of associate are as follows:

(i) a holding or parent company of the company in liquidation or any other company in the same group which is not under the control of the company in liquidation;

(ii) the spouse or relatives of a director (directors are associates but only because they are regarded as employed by the company); and

(iii) shadow directors.

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 a surety or guarantor for any of the company's debts or liabilities);[87] and

(2) the company does anything or suffers anything to be done which has the effect of putting that creditor in a better position in the event of the company's insolvency 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, so that the statutory order of priorities is in some way disturbed.

Defences

4.3.7 The court shall not make an order against a person 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.[88] This is a question of fact. The English court's decisions and comments on the equivalent section of the Insolvency Act will be regarded as persuasive in Hong Kong.[89]

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[90]. 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).[91]

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.

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[84] A company is 'insolvent' where it is unable to pay its 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) (see section 51(3) Bankruptcy Ordinance (Cap 6)).
[85] Section 51B Bankruptcy Ordinance (Cap 6).
[86] 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).
[87] Section 50(3)(a) Bankruptcy Ordinance (Cap 6).
[88] Section 50(5) Bankruptcy Ordinance (Cap 6).
[89] See 4.4.5 and 4.4.6 of the England Chapter.
[90] Section 50(5) Bankruptcy Ordinance (Cap 6).
[91] Section 51A(2) Bankruptcy Ordinance (Cap 6).

4.4 Fraudulent conveyance[92]

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 the relevant provision is found in the Conveyancing and Property Ordinance, it applies not only to land but to all forms of property. A liquidator. creditor or other person thereby prejudiced 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 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[93]

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.[94]

Defences

4.5.4 There are no statutory defences.

4.6 Effect of floating charge

4.6.1 The relevant provision seeks to prevent an insolvent company creating a floating charge over its property to secure past debts and so prefer the creditor to which the charge is provided to the prejudice of general unsecured creditors.[95]

Conditions for setting aside

4.6.2 A liquidator of an insolvent company may treat a charge as void[96] 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[97] 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 avoid any payment received in respect of a floating charge created and enforced within the 12 months prior to the commencement of the winding-up.

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92 Section 60 Conveyancing and Property Ordinance (Cap 219).
93 Section 264B of CO and is derived from the equivalent provision under English law (section 244 IA 1986).
94 Section 264B(3) CO.
95 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 less detailed, such that English case law in respect of section 245 IA 1986 may not apply in Hong Kong.
96 No application needs to be made by the liquidator to the court unless the property is controlled by the party claiming security.
97 The date of creation being defined to be the date of creation included on the relevant registration certificate issued by the Companies Registrar – *Active Base Limited v Roderick John Sutton and Others* [2009] HKCFA 111.

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 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 meaning that a floating charge provided at such time may be challenged.

(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 creation of the security. Drawings out of the account, even if replaced by payments into the account, represent new credit for these purposes[98] – 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).

4.7 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, the company may have 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 in a formal insolvency.

4.8 Disclaimer of onerous property in case of a company that is wound up[99]

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 not withstanding 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 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 with 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 may only be effected to the extent necessary to release the company and its property from liability. Any person suffering loss or damage as a consequence of the disclaimer becomes a creditor of the company and may prove the amount of any loss as a debt in the winding-up of the company.[100]

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 lose the right to disclaim on the expiry of such period.

4.9 Avoidance of dispositions of property after commencement of winding-up.[101]

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 unless the court otherwise orders. 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 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 the disposition will not materially prejudice the company's creditors or it is likely to improve the position of all the company's creditors (for example, 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 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[102] but any person who is interested in the charge[103] may and should do so.

[98] This is known as the rule in *Clayton's Case* (1816) 1 Mer 572.
[99] Section 268 CO.
[100] Section 268(7) CO.
[101] Section 182 CO.
[102] Section 81 CO.
[103] Section 80 CO.

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 licence under a copyright.

4.10.3 Under the New CO, a number of amendments and clarifications have been made to the list of charges that require registration at the Companies Registry. Most importantly, the New CO specifically states that charges over aircraft are registrable and charges over bank accounts will not be registrable. In addition, the time period within which the security must be registered has been reduced from five weeks to one month from the date of creation of the relevant security.

4.11 New CO

Please refer to paragraph 3.6 above.

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

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 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 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.[104]

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.[105]

5.2.3 Criminal offences that may be brought against directors can be summarised as follows:

(a) Fraudulent trading (section 275 (3) CO);

(b) Fraud by officers of companies in liquidation (section 273 CO);

(c) Falsification of books (section 272 CO);

(d) Liability where proper accounts not kept (section 274 CO); and

(e) Offences by officers of companies in liquidation (section 271 CO).

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[104] Section 277(1) CO.
[105] Section 14(1) of the Magistrates Ordinance (Cap.227).

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 form part of the company's assets and be for the benefit of all creditors.

5.3.2 Only the Financial Secretary and Official Receiver may bring proceedings for disqualification on the grounds of unfitness to be a director (sections 168H and 168I).

Activity / Transaction	**Person able to bring proceedings**
Misfeasance	Official Receiver, liquidator, creditor or contributory[106]
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?

Claim / Offence	**Remedy available**
Misfeasance (s.276 CO)	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.
Fraudulent trading Criminal Liability (s.275(3) CO)	If convicted following 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 limitation) 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 the court (i) 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.

[106] 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).

Claim / Offence	Remedy available
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 (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 convicted following 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 convicted following 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.
Failure to keep proper accounts	If convicted following 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.
Offences by officers of companies in liquidation	All offences under s.271 (except for (o)). If convicted following 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 convicted following 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.
Breach of duties of skill and care	The director may be ordered to compensate the company for loss and damage 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 CO imposing a general duty on directors and other persons involved in the affairs of a company to co-operate with a liquidator, a provisional liquidator or the Official Receiver, as can be found under English law in section 235 of the Insolvency Act 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[107]

7.2.1 Any contributory, trustee, receiver, banker, agent or officer[108] 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[109].

7.3 Power to summon persons suspected of having property of the company[110]

7.3.1 Persons suspected of having in their possession property of the company or of having information concerning the company or its affairs or property may be examined in private by the court. The application is usually made by the liquidator but, if he will not, any creditor or contributory may apply.[111]

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.

7.3.3 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).

Sanctions

7.3.4 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[112]

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[113] 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).

[107] Section 211 CO.
[108] Officer includes directors, managers and secretary of the company (see 3.3 above).
[109] Company Winding-Up Rules r 67.
[110] Section 221 CO.
[111] 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 77), whereas a creditor or contributory seems to have to prove a prima facie case (*Re Rolls Razor Ltd (No 2)* [1970] Ch 576).
[112] Section 222 CO.
[113] Officer includes directors, managers and secretary of the company (see 3.3 above).

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 that person 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.[114]

7.5 Company's statement of affairs[115]

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 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) whom the liquidator or provisional liquidator considers to be capable of giving the information; and

(d) any person who is or has been within that year an officer 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.[116] 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.[117]

7.6 Sanction for failing to discover the company's property and papers[118]

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 disclose to the liquidator the property of the company and when any property was disposed of;[119]

(b) fails to deliver up to the liquidator all property of the company in their custody or control, including books and papers;[120]

(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;[121] or

(d) after the commencement of the winding-up, prevents production of books and papers relating to the company's property or affairs.[122]

7.7 Human rights

7.7.1 The Hong Kong Bill of Rights Ordinance (BORO) came into effect 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 has regarded the BORO as intended to implement the ICCPR and provide a yardstick against which to test the validity of Hong Kong law.

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.

[114] Companies (Winding-up) Rules rr.49-56.
[115] Section 190 CO.
[116] Section 190(5) CO.
[117] Section 271(1)(f) CO (see 2.4: above).
[118] Section 271 CO.
[119] Section 271(1)(a) CO.
[120] Section 271(1)(b) and (c) CO.
[121] Section 271(1)(g) CO.
[122] Section 271(1)(h) CO.

7.7.3 The application of the BORO will affect:

(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 under the BORO for judicial review or damages if the nature of the act is public. 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 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.[123]

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, or of 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.

(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 is forced labour, contrary to Article 4, is unlikely to succeed as the duties of co-operation are most likely to be viewed as part of a directors' normal civic obligations.

(c) Article 14 - 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 requirement that the interference be 'arbitrary or unlawful' 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

Information or complaints relating to offences under the CO 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.[124]

(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.[125]

[123] For further information on Hong Kong's BORO see: Jump starting the Hong Kong Bill of Rights in its Second Decade? The Relevance of International and Comparative Jurisprudence by Andrew Brynes, HKU.
[124] Section 351A of the CO.
[125] Section 4(1) of the Limitation Ordinance (Cap.347).

(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.[126] 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.[127] English case law (which a Hong Kong court would consider persuasive) 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.[128]

(iii) In relation to breaches of common law duties of skill and care by directors, the limitation period is also six years from the date on which the cause of action accrued.[129]

(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 by 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.[130]

(v) The limitation period applying to disqualification applications pursued under section 168H of the CO 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.[131] 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 that the application is pursued or where the director would not suffer any specific prejudice as a result of the delay.[132] 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[133] of the company, two years, before the commencement of its winding-up[134]. 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[135] and the Court of First Instance[136] each have criminal jurisdiction with differing sentencing powers. All summary offences may be 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,[137] all appeals from a Magistrate's decision are heard in the Court of First Instance.[138]

(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[139], 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.[140] Leave of the court is not required for this procedure to be invoked.

(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[141] by giving the Magistrate's clerk notice in writing.[142] No leave of the court is required for such an appeal to be brought.

[126] Sections 20(2) and 4(1) of the Limitation Ordinance (Cap.347).
[127] Section 20(1) of the Limitation Ordinance (Cap.347).
[128] *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).
[129] 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.
[130] Section 26 of the Limitation Ordinance (Cap.347).
[131] Section 168I(2) of the CO.
[132] 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.
[133] Defined in section 51B of the Bankruptcy Ordinance (Cap.6).
[134] Sections 266 and 266B of the CO.
[135] Section 74 of the District Court Ordinance (Cap.336).
[136] Section 12 of the High Court Ordinance (Cap.4).
[137] Section 104 of the Magistrates Ordinance (Cap.227); a magistrate may review questions of fact or law.
[138] 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.
[139] Section 105 of the Magistrates Ordinance (Cap.227).
[140] Section 105 of the Magistrates Ordinance (Cap.227).
[141] Section 113 of the Magistrates Ordinance (Cap.227).
[142] Section 114 of the Magistrates Ordinance (Cap.227).

(v) An appeal against a sentence passed by a Magistrate[143] (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.[144] 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[145] or the Court of First Instance:[146]

(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.[147]

(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 that person.[148] Where a person is not convicted on indictment, that person may still appeal to the Court of Appeal if they are sentenced to imprisonment for a term of six months or more, or if the sentence is one which the court convicting them had no power to pass.[149] An appeal in these cases may only be brought with the leave of the Court of Appeal.[150]

(viii) The Secretary of Justice may appeal to the Court of Appeal against a verdict or order of acquittal of the District Court[151] based only on matters of law. No leave of court is required for such an appeal to be brought.

(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.[152]

(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).[153] Leave to appeal is required from the Court of Final Appeal[154] which will be granted only where a point of law of great and general importance is involved or where substantial and grave injustice has been done.[155]

(b) Civil appeals

(i) Both the District Court[156] and the Court of First Instance[157] exercise civil jurisdiction. The jurisdiction to wind up a company is vested in the Court of First Instance.[158]

(ii) An appeal from a decision, judgment or order of the District Court or the Court of First Instance is heard in the Court of Appeal (subject to certain exceptions)[159]. While an appeal from the Court of First Instance is available to the parties as of right,[160] an appeal from the District Court can generally only be made with leave.[161]

(iii) An appeal from the Court of Appeal shall lie to the Court of Final Appeal.[162] 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.[163] 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.[164]

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143 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)).
144 Section 114 of the Magistrates Ordinance (Cap.227).
145 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.
146 Section 13(3)(a) of the High Court Ordinance (Cap.4).
147 Section 82 of the Criminal Procedure Ordinance (Cap.221).
148 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.
149 Section 83H of the Criminal Procedure Ordinance (Cap.221).
150 Section 83I of the Criminal Procedure Ordinance (Cap.221).
151 Section 84 of the District Court Ordinance (Cap.336).
152 Section 81A(1) of the Criminal Procedure Ordinance (Cap.221).
153 Section 31 of the Hong Kong Court of Final Appeal Ordinance (Cap.484).
154 Section 32 of the Hong Kong Court of Final Appeal Ordinance (Cap.484).
155 Section 32(1) of the Hong Kong Court of Final Appeal Ordinance (Cap.484).
156 Section 32 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.
157 Section 12 of the High Court Ordinance (Cap.4).
158 Section 176 of the CO.
159 See section 14(3) of the High Court Ordinance (Cap.4).
160 Section 14 of the High Court Ordinance (Cap.4); subsection (3) of the provision sets out the exceptions to the rule.
161 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 judgment.
162 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)).
163 Section 22(1)(a) of the Hong Kong Court of Final Appeal Ordinance (Cap.484).
164 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?

9.1 Introduction

Part X of the CO deals with the winding-up of unregistered companies. A 1997 amendment to section 326 of the CO clarified long-standing confusion as to the definition of "unregistered company" by stating that it includes a non-Hong Kong company that is registered under Part XI of the CO.[165]

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.[166]

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.[167]

Section 327(4) sets out the circumstances in which an unregistered company will be deemed unable to pay its debts.[168]

9.3 Exercise of discretion

9.3.1 The court will not assume jurisdiction to wind up foreign companies in all circumstances but has adopted the general test developed by English case law consisting of three "core" requirements. These can be summarised as follows:

(a) there must be a sufficient connection with Hong Kong which may, but does not necessarily have to, consist of assets within the jurisdiction of the Hong Kong court[169];

(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 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.[170] 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. The approach of the English court would be highly persuasive in Hong Kong.

9.4.2 Other provisions in the CO relating to directors such as those relating to the 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?

[165] Section 326(2) of the CO.
[166] Section 327(2) of the CO.
[167] Section 327(3) of the CO.
[168] Including the classic common law provision of failure to satisfy a statutory demand.
[169] 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. The Company was considered to have sufficient nexus with Hong Kong.
[170] *Re Howard Holdings Inc* [1998] BCC 549.

10.1 Nature of directors' duties

The general duties applicable 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.

10.2.2 That said, the scope of the indemnities a company can make available to a director is restricted by section 165 of the 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 In contrast D&O liability insurance is permitted and may be purchased and maintained by the company for any officer of the company or any person employed by the company as auditor. This may extend to negligence, default, breach of duty and breach of trust (save for fraud) and also cover the costs of defending an action.[171]

10.3.2 The CO also specifically permits a company to indemnify an officer or auditor against liability incurred by him in defending any civil or criminal proceedings in which judgment is given in his favour or in which he is acquitted (section 165(2)(a)) and to purchase and maintain D&O liability insurance in respect of the costs of defending and proceedings (including for fraud) (section 165(3)(b)).

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 of the 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. Section 165 of the CO 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.

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 most claims for indemnity under D&O liability insurance in Hong Kong are for the provision of defence costs to assist directors to fund the cost of defending litigation against them, the ability to insure against defence costs is a significant protection for directors.

10.4.4 Defence costs incurred in negotiating settlements (before the outcome of a trial) may 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 (although claims brought by the company itself will not be covered by insurance).

10.5.2 In all cases where insurance coverage exists, there will be no coverage for 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.[172] Most standard D&O policies would, however, exclude punitive 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.

10.5.6 Employment claims are generally excluded (but separate employment practice liability cover can be purchased).

[171] Section 165 CO.
[172] *Lancashire County Council v Municipal Mutual Insurance* [1996] 3 All ER 545.

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	Yes	Loss suffered
Breach of fiduciary duty e.g. duty to act in best interests of company etc.	Civil	Yes, but not available to cover claims brought by company	Loss suffered
Employment claims, e.g. sexual discrimination	Civil	Generally Excluded	May be substantial. Precedents include US$100m (for Cathay pilots) and HK$39m (for Cap Gemini employee)
Contract claims	Civil	Yes	Loss suffered
Tort claim, e.g. misrepresentation	Civil	Yes	Loss suffered
Keeping of books/records	Criminal	No	12 months prison Fine: HK$300,000
Misleading statements to auditors	Criminal	No	2 years prison Fine: HK$150,000
Misleading statements in prospectus	Criminal	No	3 years prison Fine: HK$700,000
Failure to disclose material interest in contract	Criminal	No	Fine: HK$50,000
Granting of loan /guarantee to director	Criminal	No	2 years prison Fine: HK$150,000
Disposal of assets, breach of restrictions	Criminal	No	6 months prison Fine: HK$50,000
Non-disclosure of Interests	Criminal	No	Fine: HK$100,000
Misrepresentation	Criminal Civil	No Yes, provided no fraud	7 years prison Fine: HK$1 million Loss suffered
False/Misleading public communications	Civil	Yes, provided no fraud	Loss suffered
Market misconduct	Criminal	No	10 years prison Fine: HK$10 million
Breach of management responsibility	Civil	Yes	Loss suffered
Air pollution	Criminal	No	12 months prison Fine: HK$500,000
Unlawful waste disposal	Criminal	No	2 years prison Fine: HK$500,000
Water pollution	Criminal	No	2 years prison Fine: HK$1 million
Carrying out projects without environmental Permit	Criminal Criminal	No No	2 years prison Fine: HK$5 million
Noise pollution	Criminal	No	2 years prison Fine: HK$5 million
Signing cheques without specifying "for and on behalf of CLP"	Civil	Yes	Value of cheque
Carrying on business for fraudulent purpose	Civil Criminal	No No	Value of debts Value of debts
Corporate manslaughter	Criminal	No	Prison - variable
Contempt of court	Criminal	No	Fine-possibly c.HK$20,000 but may be higher. Prison is also a possibility.
Liability under US securities laws	Civil[173]	Unlikely given nature of offence	

[173] There may be criminal liability as well - specialist US law advice should be taken.

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 (note that there are a number of advantages in each individual director 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 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 a finite asset of the company which should not be eroded by the advancement of defence costs to a director.

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 the policy is a contract of the company, the directors must disclose their interest under the CO. The director should be authorised to vote notwithstanding this interest. The company must disclose the fact that it purchases or maintains D&O 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 differences 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 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 conditions; and 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 must have regard to the interests of 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 duty.

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 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 in full when due. Provided that a director acts honestly and in good faith, however, for as long as there is no insolvent trading legislation in Hong Kong it is unlikely that the incurring of credit during the twilight period will result in the director being personally liable 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

Indian insolvency law distinguishes between industrial companies and other non-industrial companies. Corporate insolvency is dealt with under the Companies Act of 1956.[1] Other relevant legislation is: the Sick Industrial Companies (Special Provisions) Act 1985 (SICA) which is currently incorporated into the amended Companies Act (by the Companies (Second Amendment) Act 2002 (C(SA)A)), the Recovery of Debts due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002.

Related legislation is The Transfer of Property Act 1882, The Securities and Exchange Board of India Act 1992, the Industrial Disputes Act 1947, The Industries (Development and Regulation) Act 1951, and the Banking Regulation Act 1949.

'Twilight' period under Indian law is dealt with under the Companies Act (currently called the Companies Bill 2012).

Under the Constitution of India, the Companies Act is a central legislation which is binding on all federal states of India.

1.2 Industrial companies[2]

1.2.1 Under the incorporated provisions of SICA in the Companies Act, the board of directors of a sick industrial company are required to make a reference to the National Company Law Tribunal (the Tribunal) and to submit and prepare a scheme for the company's revival and rehabilitation (along with an application containing such particulars as may be prescribed[3]) within 180 days from the date on which the directors become aware of the relevant facts giving rise to a reference or within 60 days of final adoption of accounts.[4]

1.2.2 With the winding-up order, the company ceases to be the beneficial owner of its assets and, despite continuing as the legal owner, it is the Official Liquidator who deals with the company's property, employees and unsecured creditors.[5]

1.2.3 Any disposition of property after the commencement of the winding up is void unless approved by the court. A conditional approval may be granted subject to an undertaking being given that the person with the benefit of the transfer will on demand by the Official Liquidator deposit the amounts due and payable to the workers in full or in part to which the secured creditor and the workers would be entitled.[6]

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1 The Companies Act 1956 has, over the years, been subject to many amendments and proposed amendments. The most significant was in 2002 (the Companies (Second Amendment) Act 2002) and the latest is in 2012 (the Companies Bill 2012). Not all of these amendments have come into force (including parts of the Companies (Second Amendment) Act 2002) but they have been triggers for bring about comprehensive reforms. The Companies (Amendment) Act 2002, for example, streamlined the winding up and insolvency process. The Companies Bill 2012 is intended to replace the current Companies Act 1956. The Bill has been framed for a market-oriented economic environment as compared to the 1956 Bill which was framed for a socialistic pattern of environment and had a firm control on the working of the corporate sector. However the full impact of the current Bill is not clear in the absence of the rules; the Bill did not see through the upper house (Rajya Sabha) during the current budget session in February 2013. It will in all probability be reintroduced after the recess ie April 22 2013 but, if it does not make the cut then, it is in the danger of lapsing .In this chapter, the writer seeks to present the various amendments to the Companies Act 1956 along with the provisions from the Companies Act 1956 itself for a more updated understanding of the Indian scenario.

2 Part VIA comprising sections 424A to 424L has been inserted by the Companies (Second Amendment) Act 2002. This incorporated the provisions of SICA.

3 Section 424A (1) Companies (Second Amendment) Act 2002

4 Section 424A (4) Companies (Second Amendment) Act 2002

5 Section 447 of the Companies Act 1956 read with Rule 114 of the Companies (Court) Rules 1959.

6 Section 536 of the Companies Act 1956

1.2.4 If in the course of the winding up it appears that any business of the company has been carried on with intent to defraud creditors, the directors may be held personally liable.[7] On an application to court by the Official Liquidator, the court may make a declaration, at its discretion, which is not limited to the amount of the debts of those creditors who were defrauded. Applications to the court under section 543 of C(SA)A, read with Companies (Court Rules) R. 12 (12), enquire into the conduct of an officer[8], promoter, director, etc and compel him to repay or restore any money or property to the company or pay compensation. The court is empowered to give any further directions as it deems fit for the purpose of declaring a charge on any debt or obligation due from the company to the director, promoter, officer etc liable or on any mortgage or charge of the company's assets so held due to the fraudulent transfer. The burden of proof lies with the Official Liquidator under sections 542 & 543 of C(SA)A.[9]

1.2.5 Under section 424-I the Tribunal may, if it is of the opinion that any direction is necessary in the interest of the sick industrial company or creditors or shareholders or in the public interest, direct that the company may not, except with the prior approval of the Tribunal, dispose of any of its assets during the period of inquiry under section 424B or during the period of preparation or consideration of the scheme under section 424C. If in the course of scrutiny or implementation of any scheme or proposal, it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the sick industrial company or its undertaking, including any past or present director, manager or officer or employee of the sick industrial company has: (a) misapplied or retained or become liable or accountable for, any money or property of the sick industrial company; or (b) been guilty of any misfeasance, malfeasance, non-feasance or the breach of trust in relation to the sick industrial company, the Tribunal may order him to repay or restore the money or property or any part thereof, with or without interest, or to contribute such sum to the assets of the sick industrial company or the other person entitled by way of compensation (section 424K (2)).

1.2.6 Breach of the above is punishable with imprisonment for a term of up to three years or a fine not exceeding ten lakh rupees (section 424L).

Under the Companies Bill 2012, the distinction between sick industrial and non-industrial companies has been done away with and is addressed under the provisions of Ch. XIX sections 253 – 365. Sections 266 -267 discuss the power of the Tribunal to assess damages against delinquent directors and impose punishment for certain offences with an imprisonment term which may extend to seven years and a fine which may extend to ten lakh rupees.[10]

1.3 Non-industrial companies: Companies Act 1956

1.3.1 Under section 531 of the Companies Act, when a company is in the process of a winding up by the Tribunal, then any attachment or sale of any assets of the company without the leave of the Tribunal, and any sale proceeds must be handed over to the Official Liquidator. A sale or transfer of assets, payment for which is made by or against a company within six months before the commencement of its winding up (which if made within three months prior to the presentation of an insolvency petition on which an individual is adjudged insolvent, would be deemed in his insolvency a fraudulent preference of his creditors) shall be invalid.[11] Where a floating charge[12] has been created within twelve months prior to the commencement of the winding up proceedings, it needs to be proved beyond doubt that the company was solvent otherwise the floating charge will be invalid except to the extent of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the floating charge.[13]

1.3.2 On an application by the Official Liquidator or creditor or contributor for such fraudulent preferences, the Tribunal may declare such persons to be personally liable, without limitation, for all or any of the debts or other liabilities of the company.[14]

Under the Companies Bill 2012, the power of the Tribunal to set aside a fraudulent preference is set down under section 242 (g). If the Tribunal is satisfied that a transaction is fraudulent, it may make an order as it thinks fit for restoring the position to what it would have been if the company had not given the preference (sections 328-341). Where any person who has taken part in the promotion or formation of the company, or any person who is or has been a director, manager, company liquidator or officer of the company has been guilty of any misfeasance or breach of trust in relation to the company, the Tribunal may order him or her to repay or restore the money or property (or any part thereof) with interest at such rates as the Tribunal considers just and proper. The application to the Tribunal must be made within five years of the date of the winding up order or of the first appointment of the company liquidator in the winding up as the case may be, whichever is longer. These penalties are in addition to any criminal liability.

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7 See the Supreme Court decision in Official Liquidator v. P.A. Tendolkar (1973)43 Com Cases 382

8 Pursuant to section 2(30) Companies Act 1956, '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.

9 See Sandal Chit Fund and Financiers P. Ltd v. Narinder Kumar Sharma (1994) 79 Com Cases 25 (P&H)

10 Section 266 (1): "If, in the course of the scrutiny or implementation of any scheme or proposal including the draft scheme or proposal, it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the sick company or its undertaking, including any director, manager, officer or employee of the sick company who are or have been in employment of such company:

(a) has misapplied or retained, or become liable or accountable for, any money or property of the sick company; or

(b) has been guilty of any misfeasance, malfeasance, non-feasance or breach of trust in relation to the sick company,

it may, by order, direct him to repay or restore the money or property, with or without interest, as it thinks just, or to contribute such sum to the assets of the sick company or the other person, entitled thereto by way of compensation in respect of the misapplication, retainer misfeasance, malfeasance, non-feasance or breach of trust as the Tribunal thinks just and proper, provided that such direction by the Tribunal shall be without prejudice to any other legal action that may be taken against the person including any punishment for fraud in the manner as provided in section 447.

If the Tribunal is satisfied on the basis of the information and evidence in its possession with respect to any person who is or was a director or an officer or other employee of the sick company, that such person by himself or along with others had diverted the funds or other property of such company for any purpose other than the purposes of the company or had managed the affairs of the company in a manner highly detrimental to the interests of the company, the Tribunal shall, by order, direct the public financial institutions, scheduled banks and State level institutions not to provide, for a maximum period of ten years from the date of the order, any financial assistance to such person or any firm of which such person is a partner or any company or other body corporate of which such person is a director, by whatever name called, or to disqualify the said director, promoter, manager from being appointed as a director in any company registered under this Act for a maximum period of six years.

(3) No order shall be made by the Tribunal under this section against any person unless such person has been given a reasonable opportunity of being heard."

Section 267: "Whoever violates the provisions of this Chapter or any scheme, or any order, of the Tribunal or the Appellate Tribunal or makes a false statement or gives false evidence before the Tribunal or the Appellate Tribunal or attempts to tamper with the records of reference or appeal filed under this Act, shall be punishable by imprisonment for a term which may extend to seven years and with fine which may extend to ten lakh rupees."

11 See section 531 of the Companies Act 1956

12 See provisions 332 of the Companies Bill 2012

13 See section 534 of the Companies Act 1956

14 See section 542 of the Companies Act with Rule 11(18) of the Companies (Court) Rules 1949

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?

Insolvency – related liability

Directors may find themselves liable for acts which take place during the "twilight" period as a consequence of 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, which may take on particular significance if a company finds itself in financial difficulties.

2.1 Misconduct by officers of companies in liquidation[15]

2.1.1 A past or present officer of a company commits an offence if that person:

(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 they direct, all movable and immovable property of the company in his custody or under his control, and which they are required by law to deliver up;

(c) does not deliver up to the liquidator, or as they direct, all books and papers of the company in his custody or under his control and which they are required by law to deliver up;

(d) within the 12 months before the commencement of the winding up or at any time thereafter, conceals any property of the company valued at 100 rupees or more, or conceals any debt due to or from the company;

(e) within the 12 months before the commencement of the winding up or at any time thereafter, fraudulently removes any property of the company valued at 100 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 12 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 12 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 12 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 12 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 12 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 12 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;

[15] Section 538 Companies Act 1956

(o) within the 12 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 the acts 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 they had no intent to defraud; and

(ii) to a charge under (a), (h), (i) and (j), if the accused proves that they had no intent to conceal the true state of affairs of the company or to defeat the law.

The above offence is incorporated under section 336 of the Companies Bill 2012, which remains similar to the provisions under the 1956 Act, save for the offence of fraud which is laid down under section 337 of the Companies Bill 2012.

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

(a) has, by false pretences or by means of any other fraud, induced any person to give credit to the company;

(b) with intent to defraud creditors of the company or any other person, 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 property of the company; or

(c) with intent to defraud creditors of the company, has concealed or removed any part of the property of the company since the date of any unsatisfied judgment or order for payment of money obtained against the company or within two months before that date,

he shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees.

2.2 Defrauding creditors[16]

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;

(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 judgment 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.

The liability for fraudulent conduct of business is laid out in section 339 of the Companies Bill 2012. Where any business of a company is carried on with such intent or for such purpose, every person carrying on the fraudulent conduct shall be liable for action under section 447 of the Companies Bill 2012. The prescribed punishment is imprisonment for a minimum term of six months extendable to ten years and/or a fine equal to the minimum amount involved in the fraud, which may be extended to three times the amount involved in the fraud. (This offence will, under the Companies Bill 2012, effectively replace both the offence of defrauding creditors and the offence of fraudulent conduct of the company's business referred to in 2.5 below.)

[16] Section 540 Companies Act 1956

2.3 Maintenance of improper accounts[17]

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 an 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 the officer acted honestly and that, in the circumstances in which the business of the company was carried on, the default was excusable.

Where proper books of account were not kept by the company throughout the period of two years immediately preceding the commencement of the winding up, every officer of the company who is in default shall be punishable with an imprisonment term of not less than one year extendable to three years and with a fine of not less than one lakh rupees extendable to three lakh rupees (section 338 Companies Bill 2012).

2.4 Falsification of company's books[18]

2.4.1 An offence is committed if any officer or contributor 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.

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.

The above offence applies under the Companies Bill 2012 where a person destroys, mutilates or falsifies, or conceals or tampers or unauthorisedly removes, or is a party to the destruction, mutilation or falsification or concealment or tampering or unauthorised removal of, documents relating to the property, assets or affairs of the company or the body corporate (section 447 of the Companies Bill 2012). The prescribed punishment is imprisonment for a minimum term of six months extendable to ten years and/or a fine at least equal to the amount involved in the fraud, which may be extended to three times the amount involved in the fraud.

2.5 Fraudulent conduct of company's business[19]

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;

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 2.5.3 (b) above, there should be an element of proportionality (in terms of compensation versus punitive damages) albeit the court's discretion is very wide.

(d) There is no specified period.

(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 they honestly believed that, for example, any new credit incurred would ultimately be repaid in full.

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[17] Section 541 Companies Act 1956
[18] Section 539 Companies Act 1956
[19] Section 542 Companies Act 1956

2.6 Delinquency, breach of trust & misfeasance: directors and others[20]

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 of Companies, in making its report, will be required to give the person concerned an opportunity to state his case.

This liability has ceased to be purely civil under the current Bill if, in the course of the scrutiny it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the sick company or its undertaking, including any director, manager, officer or employee of the sick company who are or have been in employment of such company – has misapplied or retained, or become liable or accountable for, any money or property of the sick company or has been guilty of misfeasance, non-feasance or breach of trust in relation to the sick company, it may, by order direct him to repay or restore the money or property with or without interest or to contribute such sum to the assets of the sick company or the other person entitled thereto by way of compensation in addition to the punishment for fraud as laid out in provision 447 of the Bill.

2.7 Misfeasance proceedings[21]

2.7.1 An offence is established if, in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal, it appears to the Board for Industrial and Financial Reconstruction 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.

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 ten 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 person has acted honestly and reasonably and the court concludes that they ought fairly to be excused.

Under the Companies Bill 2012, the Tribunal, on the application of the official/company liquidator or any creditor or contributor of the company, may declare that any persons who were knowingly parties to the carrying on of the business with intent to defraud creditors or for any fraudulent purpose shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as per the directions of the Tribunal.[22]

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[20] Section 543 Companies Act 1956

[21] Section 424K Companies Act 1956

[22] Section 339(1): "If in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or any other persons or for any fraudulent purpose, the Tribunal, on the application of the Official Liquidator, or the Company Liquidator or any creditor or contributory of the company, may, if it thinks it proper so to do, declare that any person, who is or has been a director, manager, or officer of the company or any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Tribunal may direct: provided that on the hearing of an application under this sub-section, the Official Liquidator or the Company Liquidator, as the case may be, may himself give evidence or call witnesses.

(2) Where the Tribunal makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration and, in particular:

(a) make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf;

(b) make such further order as may be necessary for the purpose of enforcing any charge imposed under this sub-section.

(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in sub-section (1), every person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be liable for action under s.447.

(4) This section shall apply, notwithstanding that the person concerned may be punishable under any other law for the time being in force in respect of the matters on the ground of which the declaration is to be made."

(Section 339 speaks of liability for fraudulent conduct of business. Section 340 speaks of the power of tribunal to assess damages against delinquent directors etc)

2.8 Directors and managers with unlimited liability[23]

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 they 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 they ceased to hold office a year or more before the commencement of the winding up;

(b) a past director or manager shall not be liable to make a further contribution in respect of debts or liability of the company incurred or entered into after they 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.

2.9 Offences under Part VIA of the Companies Act 1956[24]

2.9.1 Any person who violates any provision of Part VIA of the Companies Act or any scheme or order of the Tribunal or the Appellate Tribunal or who furnishes a false statement and/or evidence to the Tribunal or attempts to tamper with the records of reference or appeal filed under the Companies Act, shall be punished with imprisonment for a term of up to three years and a fine.

2.9.2 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 Tribunal 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

2.10 Removal of managerial personnel[25]

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 if the business has been conducted and managed in a manner which is likely to cause, or has caused, serious injury or damage to the interests 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 the public interest, the Central Government may, in conjunction with the Company Law Board, by order, remove from office any director or other person concerned.

This power of removal is now vested with the Tribunal on a complaint by any member of a company or central government about the conduct of the company being prejudicial to its interests or its members or any class of members. It will also provide such member with a right to apply under section 244 of the Companies Bill 2012 for an order. On an application under section 241(h), the Tribunal may ask for the removal of the managing director, manager or any of the directors of the company and ask for recovery of undue gains made by any such person (section 241(i)).

2.12 Reduction in membership[26]

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.

The Companies Bill 2012 will introduce the concept of single-member companies. If a company limited by guarantee or a single-member company enters into a contract, the terms of the contract or offer will need to be recorded in the minutes of the first meeting with the board of directors.

2.13 Misdescription of name[27]

In any contract of a company, if its name is not properly indicated, those responsible shall be personally liable.

2.14 Fiduciary and common law duties owed to the company

Directors owe a number of fiduciary and common law duties to the company. These include:

(a) 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;

(b) a duty to act with honesty;

(c) a duty to account for any profits made;

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[23] Section 427 Companies Act 1956
[24] Section 424L Companies Act 1956
[25] Sections 388B, 388D & 388E Companies Act 1956
[26] Section 45 Companies Act 1956
[27] Section 147 Companies Act 1956

(d) a duty not to exploit corporate opportunities to their own advantage;

(e) 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;

(f) a duty to repay to the company any profit they make on shares in the company; and

(g) 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.

2.15 Disqualification of a director[28]

A person shall not be appointed as a director of a company if they have been found to be of unsound mind; they are an undischarged insolvent; they have applied to be adjudicated as an insolvent and their application is pending; they have 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; they have 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 them from an appointment as a director has been passed by the court.

Under the Companies Bill 2012 (section 266), if in the course of the scrutiny or implementation of any scheme or proposal it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the sick company or its undertaking - including any director, manager, officer or employee of the sick company – has misapplied or retained, or become liable or accountable for, any money or property of the sick company or has been guilty of any misfeasance, malfeasance, non-feasance or breach of trust they would be punished with both the monetary penalty and punishment laid down in section 447. The liability for fraudulent conduct of business is set down in section 339.

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

3.1.1 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 to 'officers' of the company (sometimes both past and present officers) and, in some cases, to 'managers' of the company.

3.2 Managers and officers

3.2.1 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, is responsible for 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.[29]

3.2.2 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[30]. "Secretary" means the person, if any, who is appointed to perform the duties, which may be performed by a secretary.[31]

3.2.3 An officer of the company (regardless of whether they are 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.[32]

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28 Section 274 Companies Act 1956
29 Section 2(24) Companies Act 1956
30 Section 2(30) Companies Act 1956
31 Section 2(45) Companies Act 1956
32 Section 5 Companies Act 1956

3.3 Nominee and de facto directors

3.3.1 (a) A nominee director is not supposed to be in charge of a company's affairs. They are not liable for failures by the company to comply with the 1956 Act or other regulatory laws. Nominee directors are mainly appointed by secured creditors pursuant to the right to appoint a member on the board of funded companies. Such a nominee may be an executiveof the secured creditor bank or financial institution or may sometimes be a professional. They become an officially appointed director and has voting rights. Their main obligation is to ensure fair utilisation and application of the financial assistance lent. They also keep an eye on the company's affairs though is neither responsible for nor involved in the day to day affairs of the company. Since they are not involved in management, there has been a debate over the liabilities they may incur in case of fraud or wrongful action by the company. There are conflicting views of the court on this issue.

(b) A nominee director suffers from an essential conflict of duty and interest. They owe their duty to the person who nominated them 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.

3.3.2 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 hold a person as a de facto director, there must be conclusive evidence that they were the sole person directing the affairs of the company or that they acted on an 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.

Every company shall maintain a register containing such particulars of its directors and key managerial personnel which shall include details of securities held by each of them in the company or its holding, subsidiary, subsidiary of the company's holding company or associate companies. Key managerial personnel means the CEO or the Managing Director or the manager, the company secretary, the whole time director, the chief financial officer and any such other officer as may be prescribed. There is a prohibition on forward dealings in securities of company by director or key managerial personnel. Any such contravention will be punishable with imprisonment for a term which may extend to two years or a fine which shall not be less than one lakh rupees and which may extend to five lakh rupees or both (section 194).

Provisions have been introduced with regard to the selection of independent directors, their duties and responsibilities and an ethical code for conduct. However, their duties and responsibilities have been 'liability proofed' in that an independent director shall not during the period of three years be appointed in or be associated with the company in any other capacity either directly or indirectly and shall be held liable only in respect of acts of omission or commission by the company which occur with his knowledge attributable through Board Processes and with his consent or connivance or where they have not acted diligently.

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

As in most legal systems, and 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 a 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 period prior to the company's insolvency.

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.

Fraudulent preference in the Companies Bill 2012 has been laid down in section 328. If the Tribunal is satisfied that there has been a preferential transfer of property, movable or immovable, or any delivery of goods, payment, execution made, taken or done by or against a company within six months before making a winding up application, the Tribunal may declare such transaction invalid and restore the position.

4.4 Preferences

A transaction will be a preference if it puts a creditor in a better position than they 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 section 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 they 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.

Any transfer of property, movable or immovable, or any delivery of goods, made by a company not being made in the ordinary course of its business, if made within a period of one year before the presentation of a petition for winding up by the Tribunal or the passing of a resolution for voluntary winding up of the company, will be void. Similarly any transfer or assignment by a company of all its property or assets to trustees for the benefit of all its creditors will be void (sections 329-330 Companies Bill 2012).

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.

As per sections 330 & 334 of the Companies Bill 2012, any transfers or assignments by the company of all of its property or assets to trustees for the benefit of all its creditors will be void. Similarly in the case of voluntary winding up, any transfer of shares in the company and any alteration in the status of the members of the company, made after the commencement of the winding up, will be void.

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 disproving the allegation).

4.7 Avoidance of floating charges for past value[33]

Where a company is being wound up, a floating charge on the undertaking or property of the company created within the 12 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 5% (or such other rate as may be notified by central Government in the official Gazette).

This remains unchanged and is now contained in section 332 of the Companies Bill 2012.

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: [34]

(a) land burdened with covenants;

(b) shares or stock in companies;

(c) any other property which is unsaleable or is not readily saleable due to 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.

The company liquidator may notwithstanding that he has endeavoured to sell or has taken possession of the property or exercised any act of ownership in relation thereto, with the leave of the Tribunal at anytime within twelve months after the commencement of the winding up or such extended period as may be allowed by the Tribunal disclaim the property:[35]

Provided that the company liquidator was not aware of the existence of any such property within one month from the commencement of the winding up, the power of disclaimer may be exercised at any time within 12 months after the liquidator becomes aware of such property, such extended period as is allowed by the Tribunal.

The disclaimer shall operate to determine as from the date of disclaimer the rights and interest and liabilities of the company in or in respect of the property disclaimed.

In case of leasehold property, the Tribunal shall not make a vesting order in favour of any person claiming under the company unless that person is subject to the same liabilities and obligations as the company was subject to under the lease at the commencement of the winding up or, if the Tribunal thinks fit, subject only to the same liabilities and obligations as if the lease had been assigned to that person at that date.

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:[36]

(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 property or effects of the company after the commencement of the winding up will be void.

Any transfer without the sanction of the company liquidator and any alteration in the status of the members of the company, made after the commencement of the winding up, will be void (section 334).

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;

[33] Section 534 Companies Act 1956
[34] Section 535 Companies Act 1956
[35] Section 333 of the Companies Bill 2012
[36] Section 537 Companies Act 1956

(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 of Companies which is conclusive evidence that the requirements as to registration have been complied with. Registration must be effected within 30 days of the creation of the charge.

4.10.3 Upon registration, the charge becomes binding on the company even in the event of its winding up and on every subsequent purchaser or encumbrancer 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.

Registration of charges is dealt with under Ch.VI of the Companies Bill 2012. It is the duty of every company creating a charge within or outside India on its property or assets or any of its undertakings, whether tangible or otherwise and situated within or outside India, to register it with the Registrar of Companies within 30 days of its creation (section 77). If any company contravenes any provision of this chapter the company shall be punishable with a fine of not less than one lakh rupees extendable to ten lakh rupees. Every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months or a fine which shall not be less than 25,000 rupees extendable to six months, or both (section 86).

4.11 Avoidance of voluntary transfer

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.

Any transfer of property, movable or immovable or any delivery of goods, made by a company not being made in the ordinary course of its business if made within a period of one year before the presentation of a petition for winding up by the Tribunal or the passing of a resolution for voluntary winding up of the company, will be void. Similarly any transfer or assignment by a company of all its property or assets to trustees for the benefit of all its creditors will be void (sections 329-330 Companies Bill 2012).

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 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 whose sanction these proceedings would have no effect.

Within three weeks from the date of passing of a winding up order, the company liquidator[37] shall make an application to the Tribunal for the constitution of a winding up committee to assist and monitor the progress of the liquidation proceedings. This committee will consist of – the Official Liquidator[38], a nominee of the secured creditors and a professional nominated by the Tribunal. The company liquidator will be the convenor of the meetings and monitor the proceedings relating to the following:

(i) taking over assets;

(ii) examination of the statement of affairs;

(iii) recovery of property, cash or any other assets of the company including benefits derived therefrom;

(iv) review of audit reports and accounts of the company;

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[37] "Company Liquidator", in so far as it relates to the winding up of a company, means a person appointed by:
(a) the Tribunal in case of winding up by the Tribunal; or
(b) the company or creditors in case of voluntary winding up,
as a Company Liquidator from a panel of professionals maintained by the Central Government under sub-section (2) of section 275;

[38] Official liquidator "Official Liquidator" means an Official Liquidator appointed under sub-section (1) of section 359 Companies Bill 2012.

(v) sale of assets;

(vi) finalisation of list of creditors and contributories;

(vii) compromise, abandonment and settlement of claims;

(viii) payment of dividends, if any; and

(ix) any other function, as the Tribunal may direct from time to time[39].

This makes the Tribunal the custodian of the company's property and, when a report is received from the company liquidator or Central Government, an investigation under section 210 is ordered by the Tribunal with a direction to the company liquidator to file a criminal complaint against persons who were involved in the commission of the fraud.

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. The offences have to be brought to the notice of the court in order for the court to take appropriate legal action.

(a) Falsification of company's books - section 539; (section 336 (e) of the Companies Bill 2012)

(b) Fraud by officers - section 540; (section 340(1)(d)(3))

(c) Offences by officers - section 538; (section 336 (1))

(d) Fraudulent conduct of business - section 542; (section 339(1))

(e) Wrongful withholding of property - section 630; (section 452(1))

(f) False representations to creditors - section 538 (m); (section 336 (1)(i))

(g) Disqualification of a director - section 274 (section 164).

Destruction, mutilation or falsification or concealing or tampering or being a party to the destruction of documents relating to property, assets or affairs of the company or body corporate (section 229(a)).

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 (specifically in respect of industrial companies):

(i) Violation of provisions of Part VIA or any scheme of the Tribunal – 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.

5.3 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 exist to provide access for a range of people to bring action to recover funds for the benefit of the company's creditors. The overall recovery made is distributed evenly amongst the creditors in accordance with 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 entered into by the Company.

Activity / transaction	Person able to bring proceedings
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

39 See Section 277 Companies Bill 2012

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 a 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 a fine. Now punishable with an imprisonment term of not less than three years extendable to five years and with a fine of not less than three lakh rupees extendable to five lakh rupees.
Misconduct in winding up	Imprisonment or a fine or both. Both imprisonment and fine
Falsification of company books	Up to seven years imprisonment and/or a fine. Imprisonment of not less than six months extendable to ten years and a fine of not less than the amount involved. Where public interest is involved, the term of imprisonment is a minimum of three years.
Material omissions from statements relating to the company's affairs	Imprisonment which may extend to two years or a fine or both. Prison term not less than three years extendable to five years with fine of not less than one lakh rupees but which may extend to three lakh rupees.
False representations to creditors	Imprisonment for a term, which may extend to two years and a fine. Prison term of not less than three years extendable to five years and a fine of not less than one lakh rupees extendable to three lakh rupees.
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. Remains the same with the Tribunal replacing the court
Fiduciary duties	Liability is civil. The director may be ordered to compensate for any loss or damage caused by breach of their fiduciary duty, to restore to the company any property appropriated or acquired in breach of their fiduciary duty and to account to the company for any benefit obtained in breach of their fiduciary duty. Directors' duties are laid out in detail in section 166; any contravention is punishable with a fine of not less than one lakh rupees which may extend to five lakh rupees (section 166(7)). Under section 172, if a company contravenes any of the provisions for which no specific punishment is provided, then the company and every officer of the company who is in default shall be punishable with a fine which is not less than 50,000 rupees but which may extend to five lakh rupees.
Duties of skill and care	Liability is civil. The director may be ordered to compensate the company for all damage caused by breach of their fiduciary duty. Directors' duties are laid out in detail in section 166 any contravention is punishable with a fine of not less than one lakh rupees which may extend to five lakh rupees(section 166(7)). Under section 172 if a company contravenes any of the provisions for which no specific punishment is provided, then the company and every officer of the company who is in default shall be punishable with a fine which is not less than 50,0000 rupees but which may extend to five lakh rupees.
Fraudulent conduct of business	Up to two years' imprisonment and/or a fine. Section 339: where in the course of the winding up of a company it appears that any business of the company has been carried on with the intent to defraud creditors of the company or any other persons or for any fraudulent purpose, the Tribunal may declare such persons to be personally liable without limitation of liability for all or any of the debts or other liabilities of the company as the Tribunal may direct.
Fraud by officers	Up to two years imprisonment and/or a fine. Imprisonment term of not less than one year extendable to three years and a fine of not less than one lakh rupees extendable to three lakh rupees.
Destroying, mutilating company documents including making an omission in a document	Liability is criminal. Imprisonment for a term which may extend to two years and/or a fine. Under section 229 such a person shall be punishable as per the provisions of section 447 – imprisonment for a term of not less than six months extendable to ten years and also shall be liable to a fine of not less than the amount involved in the fraud extendable to three times the amount involved.

Offence	Remedy available
Conduct rendering a director unfit to be a director	Liability is civil. The liability is as provided under section 447 above, and the grounds of disability are laid down under section 164 of the Companies Bill 2012.
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 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 Tribunal on an application moved before it. Under section 328 where the Tribunal is satisfied that there is a preference transfer of property taken or done by or against the company within six months before making winding up application, the Tribunal may declare such transaction invalid and restore position.
Transactions defrauding creditors	Liability is criminal as well as civil. An action for criminal breach of trust can be brought if the transaction involved 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. When it is an auditor who has contravened with the intention to deceive the creditors, they shall be punishable with an imprisonment term extendable to one year and with a fine of not less than one lakh rupees extendable to 25 lakh rupees. The persons in charge of management of the company shall, when found responsible with intention of deception or defraud, even after the company has been reported dissolved, be held jointly and severally liable to any person or persons who incurred loss or damage and be punishable for fraud as provided under section 447 of the Companies Bill 2012.
Extortionate credit transactions	Liability is civil. A civil action for setting aside such transactions can be brought. Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by a special resolution within three months from the date on which such contract or arrangement was entered into, the contract or arrangement will be voidable at the option of the Board and if such contract or arrangement is with a party related to any director or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it. Any director or any other employee of a company who has entered into or authorised the contract or arrangement in violation of the provisions of this section shall – in the case of a listed company be punishable with imprisonment for a term which is extendable to one year or a fine of not less than 25,000 rupees extendable to five lakh rupees, or both; in the case of any other company, a fine of not less than 25,000 rupees extendable to five lakh rupees.
Avoidance of a floating charge	Liability is civil. The court can declare that the floating charge is invalid in whole or in part. Except for the amount of cash paid to the company at the time of, or subsequent to the creation of and in consideration for the charge, together with interest at the rate of 5% per annum or such other rate as may be notified by Central Government.
Non-submission of audited accounts	Liability is criminal. Imprisonment is for a term which may extend to one year and a fine. The company is punishable with a fine of not less than 25,000 rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or a fine which shall not be less than 10,000 rupees extendable to one lakh rupees or both. Where an auditor contravenes they shall be punishable a fine of not less than 25,000 rupees extendable to five lakh rupees.
Wilful refusal to furnish information relating to the affairs of producer companies	Liability is criminal. Imprisonment is for a term which may extend to six months and a fine. Where any company has not furnished within the time specified, the company shall be liable to a penalty of 25,000 rupees for each such refusal or default. With regard to producer companies, the provisions of Part IXA of the Companies Act 1956 continue to apply.

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 the 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 or the 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 Tribunal[40] or the Official Liquidator[41] who can call for information.

Under section 284 the promoters, directors, officers and employees, who are or have been in employment of the company or acting or associated with the company shall extend full cooperation to the company liquidator in discharge of their functions and duties. Where any person fails to discharge their obligations, they shall be punishable with imprisonment extendable to six months or with fine extendable to 50,000 rupees, or both.

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 they require;

(d) those who are, or have within that one year been, officers, 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 Tribunal, 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 of SICA, they 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[42]

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.

[40] Sections 424J, 439A and 441E Companies Act 1956
[41] Section 454 and 457(2D) Companies Act 1956
[42] Section 456 Companies Act 1956

The liquidator or the Provisional Liquidator is required to take into their custody or under their 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.[43] 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 [44]

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 their 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 power has very wide application. Such persons may be required (i) to submit an affidavit to the court containing an account of their dealings with the company; or (ii) to produce any books and papers in their custody or under their control relating to the 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 their 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[45]

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 of SICA, they shall be punished with imprisonment for a period of up to two years and fined.

7.5 Public examination of officers[46]

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 their opinion a fraud has been committed (a) by any person 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.

7.5.2 Sanction

The court may, on proof of probable cause that a contributor is about to quit India or abscond, or avoid examination, have the contributor arrested and their books and papers and movable property seized and kept safe until such time as the court may order.[47]

[43] Section 477 Companies Act 1956
[44] Section 477 Companies Act 1956
[45] Section 454 Companies Act 1956
[46] Section 478 Companies Act 1956
[47] Section 479 Companies Act 1956

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 the 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 their 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 affidavit;

(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) handle 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 proceedings except on a prosecution for giving false evidence by such statement.

7.6.6 Action taken

If the inquiry discloses a human rights violation or negligence on the 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 the 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 above. 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[48]

An application under section 543 1956 Act, which is similar to section 24 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.

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[48] Section 543 Companies Act 1956

8.3 Other offences[49]

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. 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 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 or less.

(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 Company Law 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 Second Amendment, complaints for offences committed under the 1956 Act will lie to the Tribunal. Any person aggrieved by any decision or order of the Tribunal 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 Tribunal 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.[50]

QUESTION 9

9. Foreign corporations

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

Foreign Company means any company or body corporate incorporated outside India which has a place of business in India, whether by itself or through an agent, physically or through electronic mode; and conducts any business activity in India in any other manner.

Under section 376 where a body corporate incorporated outside India is carrying on business in India ceases to carry on business in India, it may be wound up as an unregistered company.

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.[51]

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.

[49] Under the Companies Act 1956 & SICA
[50] Section 483 Companies Act 1956
[51] Section 591 Companies Act 1956

9.2 Winding up of unregistered companies[52]

9.2.1 All the provisions (including those set out in Question 2 above) with respect to winding up of a domestic company 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[53]

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 the opinion that it is just and equitable that the company be wound up.

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[54]:

(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:[55]

(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 of Companies.

9.5 Penalties[56]

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 1000 rupees, and in the case of a continuing offence, by an additional fine of up to 100 rupees for every day the default continues.

9.6 Effect of offence[57]

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.

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 foreign companies.

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 provision under Indian Law, statutory or otherwise providing for this and hence directors' and officers' insurance is not available in India.

[52] Section 583 Companies Act 1956
[53] Section 583 Companies Act 1956
[54] Section 592 Companies Act 1956
[55] Section 594 Companies Act 1956
[56] Section 598 Companies Act 1956
[57] Section 599 Companies Act 1956

QUESTION 11

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 burdens 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 of the rehabilitation scheme be required but also the directors may otherwise expose themselves to liability for serious misfeasance, malfeasance 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, and in India too, the period preceding the commencement of insolvency proceedings is vulnerable. Under Indian law, every transaction in the 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 the purpose of 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 reversing 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 whether a liquidator will try 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 first option to repurchase the asset if they 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 a charge over the assets of the company and has priority 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.

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.[58]

1.1.2 Predominantly, we are here concerned with a winding up by the National Company Law Tribunal (NCLT or Tribunal), 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:[59]

(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 of Companies 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 of the 1956 Act; or

(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[60]:

(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.[61]

1.3 Procedure for petitioning

1.3.1 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[62]. 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.[63]

A company may be wound up voluntarily if the company in general meeting passes a resolution requiring the company to be wound up voluntarily as a result of the expiry of the period of its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company should be dissolved or if the company passes a special resolution that the company be wound up voluntarily (section 304).

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[58] Section 425 Companies Act 1956
[59] Section 433 Companies Act 1956
[60] Section 434 Companies Act 1956
[61] 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.
[62] Section 439 Companies Act 1956
[63] 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.

1.5 Commencement of winding up by the court[64]

(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.[65]

Section 271 (b) states that a company may on a petition under section 272 be wound up by the Tribunal if the company has, by special resolution, resolved that the company be wound up by the Tribunal.

(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.

See section 271 Companies Bill 2012.

1.6 Powers of winding up court[66]

1.6.1 On hearing a winding up petition, the court may:

Additionally, under the Companies Bill 2012 section 280 provides the jurisdiction of the Tribunal to entertain or dispose of – any suit or proceeding by or against the company; any claim made by or against any of its branches in India; any application made under section 233; any scheme submitted under section 262.

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[67] as provisional liquidator.

At the time of passing the winding up order, the Tribunal shall appoint an official liquidator or a liquidator from the panel maintained (section 275(1)). The provisional liquidator shall be appointed from a panel maintained by the Central Government (section 275(2)).

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[68] and the Registrar of Companies.

Under the Companies Bill 2012, the Tribunal shall on an application filed by the liquidator make an order for the dissolution of the company and a copy of the order shall within 30 days be forwarded to the Registrar by the liquidator. In the event the liquidator fails to forward a copy of the order within 30 days, the liquidator will be fined which may extend to 5000 rupees for every day whilst the default continues (section 302).

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.

This remains unchanged under section 277(3).

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.

This remains unchanged; current provision is section 279.

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.

As per section 277(4) & (5), within three weeks from the date of passing the winding up order, the company liquidator shall make an application to the Tribunal for the constitution of a winding up committee to assist and monitor the progress of the liquidation proceedings. This committee shall comprise an official liquidator attached to the Tribunal, a nominee of the secured creditors and a professional nominated by the Tribunal. The Committee will assist and monitor the liquidation proceedings in taking over assets, examination of the statement of affairs, recovery of property, cash or any other assets of the company including benefits derived therefrom; reviewing audit reports and accounts of the company, selling assets, finalising the list of creditors and contributories, compromising, abandoning and settling claims, paying dividends and any other function as directed by the Tribunal.

1.7.5 Where a winding up order has been made or where a provisional liquidator has been appointed, the liquidator shall take into their custody or under their control, all the property effects and actionable claims to which the company is or appears to be entitled.

For the procedure of winding up order see 1.7.6 and with regard to Provisional Liquidator as per section 275(2) the appointment shall be from a panel maintained by the Central Government. Where a Provisional Liquidator is appointed by the Tribunal, the Tribunal may limit or restrict their powers by the order appointing him or by a subsequent order, otherwise they shall have the same powers as a liquidator.

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[64] Section 441 Companies Act 1956

[65] 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.

[66] Section 443 Companies Act 1956

[67] The Official Liquidator is a full-time officer appointed by the Central Government and attached to the court.

[68] 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.

1.7.6 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.

Where a winding up order has been made or where a Provisional Liquidator has been appointed, the liquidator shall on the order of the Tribunal take into their custody or control all the property, effects and actionable claims to which the company is or appears to be entitled and take such steps and measures as may be necessary to protect and preserve the property of the company. All property and effects of the company shall be deemed to be in the custody of the Tribunal from the date of the order for the winding up of the company (section 283).

1.7.7 The liquidator shall convene separate meetings of creditors and contributories for the appointment of a 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.

See above 1.7.4 for committee. As per section 294, the company liquidator shall maintain proper and regular books of account including accounts of receipts and payments and these shall be presented to the Tribunal at prescribed times and the Tribunal shall cause the accounts to be audited in such manner as it thinks fit and when the accounts have been audited, one copy shall be filed by the company liquidator with the Tribunal and the other copy with the Registrar which shall be open to inspection by any creditor, contributor or person interested.

1.7.8 As soon as possible after making a winding up order, the court shall settle a list of contributors 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 contributor 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 their hands to which the company is prima facie entitled.

Section 299 states that the Tribunal may at any time after the appointment of a Provisional Liquidator or the passing of a winding up order, summon before it any officer of the company or person known or suspected to have in their possession any property or books or papers of the company, or known to be indebted to the company.

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 their 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.

This remains unchanged under section 300 of the Companies Bill 2012.

1.8 Effect of winding up order[69]

1.8.1 An order for winding up a company shall operate in favour of all the creditors and all the contributors of the company as if it had been made on the joint petition of a creditor and of a contributor.

This remains unchanged with the current provision being section 278.

1.9 Liability

1.9.1 As contributors 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.[70]

Section 285(1): as soon as possible after the passing of a winding up order by the Tribunal, the Tribunal shall settle a list of contributors, and cause rectification of register of members in all cases where rectification is required. In settling the list of contributors the Tribunal shall distinguish between those who are contributors in their own right and those who are contributors by being representatives of or liable for the debts of others. While settling the list of contributors, the Tribunal shall include every person who is or has been a member and who shall be liable to contribute to the assets of the company an amount sufficient for payment of the debts and liabilities and the costs, charges and expenses of winding up, and for the adjustment of the rights of the contributors among themselves following the conditions laid down in the provision.

1.9.2 As directors and managers[71] 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 their liability, if any, to contribute as an ordinary member, be liable to make a further contribution as if they were, at the commencement of the winding up, a member of an unlimited company.[72]

This has remained unchanged under section 286.

[69] Section 447 Companies Act 1956
[70] Section 426 Companies Act 1956
[71] Section 427 Companies Act 1956
[72] 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.

1.10 Dissolution of company[73]

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.

As per section 318 of the Companies Bill 2012 as soon as the affairs of a company are fully wound up, the company liquidator shall prepare a report of the winding up showing that the property and assets of the company have been disposed of and its debt fully discharged or discharged to the satisfaction of the creditors and thereafter call a general meeting of the company for the purpose of laying the final winding up accounts before it. If the majority of the members of the company after considering the report of the company liquidator are satisfied that the company shall be wound up, they may pass a resolution for its dissolution. Two weeks from the date of the meeting the liquidator will file an application along with the report to the Tribunal for passing an order of dissolution of the company.

[73] Section 481 Companies Act 1956

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[1] January 2004.1 The Bankruptcy Law,[2] which dates back to 1942, was also substantially amended – in an effort to render insolvency proceedings more flexible and expeditious – through a long series of legislative measures adopted between 2005 and 2012. The first part of the Bankruptcy Law reform, enacted by the Italian Government in March 2005,[3] introduced a set of new rules mainly relating to clawback actions, compositions with creditors and out-of-court restructuring procedures. The second part of the Bankruptcy Law reform, adopted in January 2006,[4] primarily dealt with the ordinary bankruptcy proceeding (fallimento) with the intention to simplify and shorten the applicable procedures.[5] In September 2007,[6] a so-called corrective decree introduced amendments intended, in particular, to narrow the scope of business enterprises subject to bankruptcy and to address certain issues arisen during the initial implementation of the reformed Bankruptcy Law. The third generation of legislative interventions took place between 2009[7] (introducing certain amendments and adjustments to compositions with creditors) and 2010[8] (giving, among other things, super-priority status to certain financing granted by banks and shareholders in the context of restructuring procedures, provided that certain conditions are met). Finally, in 2012[9] the Italian Government (with the so-called Development Decree) introduced important amendments to the Bankruptcy Law intended to facilitate the restructuring of distressed companies, mainly through quicker access to judicial composition with creditors, interim financing, and a new special form of composition aimed at ensuring the continuity of the debtor's business (*concordato* con continuità aziendale).

1.1.3 Given the size and extent of the legislative interventions listed above and the absence of a meaningful body of case law on certain rules recently introduced, a number of legal issues involving corporations in the "twilight period" are still the subject of debate among legal scholars. In dealing with both company and bankruptcy law issues, therefore, this chapter will provide an account of the prevailing interpretations of the new rules and, where applicable, 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 laws or follow the prevailing scholarly interpretations.

1.1.3.1 Unless otherwise specified, the description of relevant Italian law provisions below applies to all companies, whether joint-stock corporations (società per azioni, hereinafter SpA) or limited liability companies (società a responsabilità limitata, hereinafter SRL).[10]

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1 Legislative Decree No. 6 of 17 January 2003.
2 Royal Decree No. 267 of 16 March 1942, as amended.
3 Decree-law No. 35 of 14 March 2005, ratified into Law No. 80 of 14 May 2005.
4 Legislative Decree No. 5 of 9 January 2006, which came into effect on 16 July 2006.
5 The main areas affected by the second part of the reform were: (a) the scope of business enterprises subject to bankruptcy; (b) the roles of the bankruptcy court, trustee and creditors' committee; (c) the consequences of bankruptcy on executory contracts; (d) continuation of the debtor's business operations; (d) the conversion of liquidation proceedings into reorganisations; and (e) the discharge from unpaid debt.
6 Legislative Decree No. 169 of 12 September 2007, which came into effect on 1 January 2008.
7 Law No. 69 of 17 June 2009.
8 Decree-law No. 78 of 31 May 2010.
9 Decree-law No. 83 of 15 June 2012, ratified into law, with amendments, by the Italian Parliament on 3 August 2012.
10 Decree-laws No. 1 of 24 January 2012 and No. 83 of 15 June 2012 introduced two types of simplified limited liability companies (which may be established with a share capital of only 1 Euro): società semplificata a responsabilità limitata (available only to young entrepreneurs) and *piano attestato di risanamento*. For the purposes of this chapter the reference to SRL will include also these new types.

1.1.3.2 Under the new company law, SpA may opt for one of three corporate governance systems:

(i) the so-called traditional system, in which alongside the board of directors (or a single director) there exists a separate board of statutory auditors (collegio sindacale) with audit and monitoring functions;

(ii) the two-tier system, whereby the members of the management board are appointed by a supervisory board, which also performs audit and monitoring functions;

(iii) the one-tier system, whereby audit and monitoring functions are exercised by an audit committee composed by independent members of the board of directors.

1.1.3.3 Unless otherwise specified, any reference herein to "directors" 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 statutory auditors and of the supervisory board will be addressed in paragraphs 3.3 and 3.4 below.

1.1.3.4 The board of statutory auditors is mandatory in SRL only when the company's capital is at least Euro 120,000 or when the company's size exceeds certain thresholds.[11] The board of statutory auditors in SRL has the same powers and duties as boards of statutory auditors in SpA, with the addition of the duty to audit the company's financial statements (under SpA default rules, the board of statutory auditors does not audit the financial statements[12] and in SpA with shares listed on an Italian or EU stock exchange, the company's accounts must be audited by an independent audit company).

1.1.4 The Bankruptcy Law is the main piece of legislation dealing with ordinary bankruptcy proceedings (fallimento) in Italy, as well as various proceedings aimed at avoiding bankruptcy through (a) a court-supervised composition with creditors (*concordato* preventivo),[13] (b) an out-of-court restructuring agreement ratified by the court (*accordo di ristrutturazione*)[14] or (c) a recovery plan assessed by an independent expert (*piano attestato di risanamento*).[15] [16] The framework rules set forth by the Bankruptcy Law also apply – with certain exceptions – to special insolvency proceedings applicable, among others, to banks and insurance and investment services companies (*liquidazione coatta amministrativa*).

1.1.4.1 Until the recent reforms, the Bankruptcy Law did not provide for effective reorganisation 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,[17] subsequently amended in 1999[18] (the so-called "Prodi Law"), which introduced a new insolvency procedure aimed at the reorganisation 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.[19]

1.1.4.2 The special composition with creditors available to large insolvent companies since December 2003 was significantly more flexible than the ordinary regime generally available to all business enterprises (*concordato* preventivo). The 2005 Bankruptcy Law reform amended the general regime to make it substantially similar to the special *concordato* of large insolvent companies. Further improvements were made in 2009 and 2012. The amended *concordato* preventivo – now available to all companies regardless of their size – may provide for: (a) the division of creditors into different classes; (b) the differential treatment of creditors belonging to different classes; (c) the restructuring of debts in any form, including a debt-for-equity exchange; (d) the transfer of the insolvent company's assets to an assignee (assuntore); (e) the authorisation to suspend or terminate executory contracts (with indemnification to the other party); (f) the authorisation of interim financing (with super priority) necessary to fund the ongoing operations of the company during the proceeding; and (g) the authorisation to pay for goods or services received prior to filing the *concordato* application. The *concordato* preventivo must be approved by creditors holding a majority of the debt,[20] is submitted to the court for ratification together with a third-party expert report on the accuracy of the financial data and feasibility of the plan and, once ratified by the court, is binding on all creditors. Financing granted by third parties and, up to certain thresholds, by shareholders in the context of a *concordato* preventivo are given super priority status. Moreover, transactions, security interests and payments entered into, granted or made pursuant to a *concordato* preventivo are exempted from clawback.

1.1.4.3 The 2012 Development Decree introduced a special form of *concordato* preventivo specifically aimed at ensuring business continuity, as opposed to winding down of the business (the so-called *concordato* con continuità aziendale). This special form of composition is available if the proposal to creditors provides for (a) the continuation of the business by the debtor, (b) the sale of the business as a going concern, or (c) the contribution-in-kind of the business as a going concern to one or more companies (even if newly incorporated). In these cases, the *concordato* application must include a certification from an independent expert that the continuation of the business would enhance creditors' recovery. Under this special *concordato*, the payment of secured creditors may be deferred up to one year after final court ratification of the *concordato* proposal and executory contracts may not be terminated because of the *concordato* proceedings (despite any provisions in the contracts to the contrary) and the court may authorise the debtor, based on a certification from an independent expert, to pay for goods or services received prior to filing.

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[11] Article 2477, Civil Code.

[12] By-laws of closely-held SpA not required to prepare consolidated accounts may empower the board of statutory auditors to audit their financial statements.

[13] Article 160, Bankruptcy Law.

[14] Article 182-bis, Bankruptcy Law.

[15] Article 67, paragraph 3, lett. d), Bankruptcy Law.

[16] The 2006 Bankruptcy Law reform abolished the two-year judicial moratorium proceeding (*amministrazione controllata*) – previously available to companies in temporary financial distress – since it proved substantially ineffective.

[17] Law No. 95 of 3 April 1979.

[18] Legislative Decree No. 270 of 8 July 1999.

[19] Decree-law No. 347 of 23 December 2003, ratified and amended by the Italian Parliament with Law No. 39 of 18 February 2004, and further amended by Decree-law No. 119 of 3 May 2004, ratified and amended by the Italian Parliament with Law No. 166 of 5 July 2004. In connection with insolvency of the Italian flagship carrier, Alitalia SpA, the Italian Government, through Decree-law No. 134 of 28 August 2008, ratified and amended by the Italian Parliament with Law No. 166 of 27 October 2008, extended the availability of this proceeding to reorganisations made through the divestiture of debtor's assets to third party purchasers, whether as a whole or as one or more lines of business.

[20] In addition, if the creditors are divided into different classes, the majority approval must occur in the majority of the existing classes.

1.1.4.4 The 2005 Bankruptcy Law reform introduced a new out-of-court restructuring agreement ratified by the court (*accordo di ristrutturazione*). The petition may be filed only if (a) a majority of creditors holding at least 60% of the debt have entered into the restructuring agreement, and (b) a third-party expert has certified the truthfulness of the underlying data and the feasibility of the proposed restructuring (in particular with respect to the full payment of creditors who are not party to the agreement). The restructuring agreement is not binding on creditors who are not party to it; however, transactions, security interests and payments entered into, granted or made pursuant to it are not subject to clawback.

1.1.4.5 The clawback exemption is also extended to transactions, security interests and payments entered into, granted or made pursuant to recovery plans assessed by an independent expert appointed by the debtor (*piano attestato di risanamento*), a restructuring device introduced by the 2005 reform. The truthfulness of the underlying data and the feasibility[21] of such recovery plans – which are binding only on creditors who are party to them and must appear suitable to permit restructuring of the debt and to ensure recovery of debtor's financial condition – is assessed by an independent expert, but is not subject to any approval by the court.

1.1.4.6 The 2012 Development Decree has overhauled the filing formalities to access the *concordato* preventivo. Prior to such reform, the debtor had to file an application along with a proposal to its creditors, a feasibility assessment by an independent expert, and other documentation. The preparation of this package (and, often, informal negotiations with the main creditors) typically took a long time and, meanwhile, the operations of the debtor and relationships with its creditors were not protected. Only after the complete filing, could the debtor (and third parties) benefit from the *concordato* preventivo protections, including a stay of enforcement action against the debtor's assets, the prohibition to pay pre-petition creditors, and the requirement for the debtor to obtain court authorisation to carry out activities outside the ordinary course.

1.1.4.7 The 2012 Development Decree allows a distressed debtor to file a short-form application for admission to *concordato* preventivo. The debtor may file the proposal to creditors and the remaining documentation within a term set by the court between 60 and 120 days (with a possible further extension of up to 60 days). Alternatively, within the same term, the debtor may apply for court ratification of an out-of-court restructuring agreement (*accordo di ristrutturazione*). In the event that the debtor does not file either a *concordato* proposal or an out-of-court restructuring agreement within the prescribed term, any creditor or the Public Prosecutor may request the court to verify that the debtor is insolvent and declare it bankrupt.

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.[22] If they fail to do so and consequently aggravate the company's deficit, then they are criminally liable[23] (see paragraph 2.4.3 below) 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.

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 clawback provisions

1.3.1 For purposes of assessing the vulnerability of transactions to challenge (as opposed to the personal liability of directors), the "twilight period" is the preference period (*periodo sospetto*) prior to the opening of the ordinary bankruptcy proceeding (fallimento),[24] during which certain transactions entered into by the debtor may be voided by a judgment of the bankruptcy court upon request of the trustee in a so-called bankruptcy clawback action (*revocatoria fallimentare*).[25]

1.3.2 A company (or any other business enterprise) shall enter into bankruptcy proceedings when it becomes insolvent. The concept of "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 honoured may also conceal 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 favourable terms).[26] 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 preference 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 does not exceed one year prior to that date (see question 4). Certain transactions, however, may be voided even before the preference period commences and irrespective of whether the company is insolvent, if specific requirements are satisfied (see paragraph 4.1.2).

[21] Decree-law No. 83 of 15 June 2012 replaced the previous reference to a reasonableness assessment with a feasibility assessment that mirrors the corresponding requirement under the out-of-court restructuring agreement ratified by the court.

[22] When the company is in a situation of recoverable distress (and not insolvency), directors can take those steps necessary to access the alternative procedures mentioned above, such as a composition with creditors or a restructuring agreement.

[23] Article 217, Bankruptcy Law.

[24] The same rules basically apply in the case of *liquidazione coatta amministrativa* and *amministrazione straordinaria*.

[25] Or by the extraordinary commissioner in the *amministrazione straordinaria*.

[26] Article 5, paragraph 2, Bankruptcy Law. According to case law, a company is insolvent, inter alia, if it faces unfavourable conditions of liquidity, irrespective of the ratio of assets to liabilities, or if it has insufficient cashflow 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 unfavourable terms of access to credit due to its particular situation or general market conditions.

1.3.4 The preference period ends on the date on which the competent court orders the opening of formal bankruptcy proceedings (or, in case of *amministrazione straordinaria*, when the court declares the insolvency).[27]

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 action or omission in violation of their duties, as defined by the law and by the corporate by-laws, whenever such action or omission causes damage to the company and/or its creditors, and may also be held liable towards individual shareholders or third parties, to the extent that such action or omission causes a direct damage to them.

2.1.2 Some actions and omissions, as identified in paragraph 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 paragraph 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 paragraph 8.1).

2.1.5 As a general rule, there must be a causal link between a directors' violation and the loss incurred by the company, the creditor and/or the shareholders. 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, based on the nature of their office and on their expertise. In general, SpA non-executive directors carry no liability for damages following actions or omissions relating to the exercise of powers formally or *de facto* delegated to the executive committee or to one or more executive directors.[28]

2.2.2 However, no matter whether executive or non-executive, directors of SpA must act in an informed way[29] and are jointly and severally liable *vis-à-vis* the corporation if, being aware of actions damaging the corporation, they fail to do what is in their power to avoid or reduce the harmful consequences of such actions or omissions.[30]

2.2.3 Liability for such actions does not apply to the directors who, being without fault, promptly express in the minutes their dissent and give immediate written notice to the chairman of the board of statutory auditors.

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 organisational 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 independent auditor.[31]

2.2.4.1 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 any irregularities are found, it may order provisional measures and call a general meeting to facilitate a resolution or, in the most serious cases, remove the directors and appoint a judicial administrator.[32]

2.2.4.2 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.[33]

[27] According to the prevailing case-law interpretation, if the bankruptcy declaration occurs at the end (or during) a *concordato* procedure, the reference date to determine the preference period is moved back to the date of admission to the *concordato* proceeding. This interpretation has been substantially confirmed by an express provision introduced by the Development Decree (Article 69-bis, paragraph 2, Bankruptcy Law) that moves back the reference date to the publishing of the *concordato* application with the Companies' Register.

[28] Article 2392, Civil Code.

[29] Article 2381, Civil Code.

[30] Article 2392, Civil Code.

[31] Article 2409-octiesdecies, Civil Code.

[32] Article 2409, Civil Code.

[33] Article 149, paragraph 4-ter, Legislative Decree No. 58 of 25 February 1998.

2.2.4.3 Therefore, audit committee members who, being aware of actions damaging the corporations taken by executive directors in violation of their duties, omit to file the complaint mentioned above under paragraph 2.2.4.2 above or (if the corporation is listed) 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 action.

2.2.5 Directors of SpA are also jointly and severally liable *vis-à-vis* the corporate creditors if they fail to comply with their duties concerning the preservation of the company's assets[34] (i.e., the duties which are likely to have an impact on the company's solvency, such as rules on distributions to shareholders, formation of capital, drawing up of financial statements, issuance of bonds).

2.2.6 Since the rule described under paragraph 2.2.5 above is not replicated by the corresponding provisions applicable to SRL, corporate law scholars debate whether the liability towards creditors may be applied by analogy to SRL directors who fail to comply with the preservation duties applicable to SRL – the interpretation favoured by the prevailing case law – or whether their liability should otherwise be derived from general tort law or company law principles.

2.2.7 Directors having an interest – on their own behalf or on behalf of third parties – in a transaction carried out by the company may incur liability if they do not comply with certain rules. In particular: (a) directors must disclose their interest to the board of directors, even if such interest is not conflicting with the interest of the company; and (b) an executive director having any interest in a proposed transaction within the scope of his powers must solicit prior board approval for such transaction. The interested director is not required to abstain from voting on the resolution approving the transaction, but the resolution must state explicitly the reasons for, and the benefit to the company of, the transaction. In the event that these provisions are not complied with, or that the transaction would not have been approved without the vote of the interested director, the resolution approving the detrimental transaction may be challenged and the interested director may be held liable for damages incurred by the company as a result of the transaction.[35]

2.2.8 Moreover, directors having an interest conflicting with the company's interest may incur criminal liability (punished by imprisonment for six months to three years) if they carry out or resolve the transfer of corporate assets for the purpose of procuring an unjustified profit or other advantage to themselves or third parties and thereby intentionally cause damage to the company.[36]

2.2.9 In application of general tort law principles, directors are also liable – together with the corporation – for those damages suffered by individual shareholders and/or third parties as a direct result of their negligence or wilful misconduct.[37] So, for instance, directors issuing false financial 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 event connected with the so-called "recapitalise or liquidate rule".

2.3.2 Before describing this rule, it is worth recalling that, when an event of dissolution occurs,[38] 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.[39]

2.3.3 Upon the occurrence of an event of dissolution and until liquidators are appointed,[40] 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 provision (i.e., entering into transactions with a purpose other than the preservation of the integrity and value of corporate assets).[41] Since this provision was introduced by the 2003 company law reform, there is no settled case law as to which transactions may fall under this provision; arguably transactions which imply a material increase in the exposure of the company may fall within its scope.

2.3.4 According to the recapitalise or liquidate rule, if, as a result of losses exceeding one-third of the share capital, the share capital itself falls below the statutory minimum prescribed by the law (i.e., Euro 120,000 for SpA and Euro 10,000 for SRL), the directors must call the general meeting without delay. The shareholders will resolve whether to reconstitute the capital 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 Euro 10,000) or into a partnership (which has no minimum capital). Unless either measure is taken, the company must be dissolved.[42] The 2012 Development Decree introduced an important exception to the application of these rules to companies seeking access to *concordato* preventivo: the obligation to recapitalise or liquidate is not applicable between the date of filing of a *concordato* preventivo application (or a court-ratified restructuring agreement) and court ratification at the end of the proceeding. The purpose of this moratorium is two-fold: on the one hand it avoids interference between corporate law rules and restructuring proceedings, on the other hand it avoids automatic exposures of directors to liability for failure to activate the appropriate corporate remedies upon occurrence of a material loss of share capital, provided that the application to the relevant restructuring procedure is duly made.

34 Article 2394, Civil Code.
35 Article 2391, Civil Code.
36 Article 2634, Civil Code.
37 Article 2395, Civil Code.
38 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 recapitalised or converted into another company (see text below, paragraph 2.3.4); (iii) voluntary dissolution resolved upon by the shareholders meeting; (iv) other events identified in the by-laws.
39 Article 2484, Civil Code.
40 See paragraph 3.2.1.
41 Article 2485, Civil Code.
42 Articles 2447, 2482-ter, and 2484, No. 4), Civil Code.

2.3.5 According to the case law developed under the previous regime and confirmed after the 2003 company law reform, directors have an ongoing duty to monitor the company's accounts to determine whether net assets fall below the thresholds prescribed by the law. This implies that directors breach the recapitalise or liquidate rule if, during the fiscal 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 recapitalise or liquidate rule will 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*).[43] The prerequisite for both of these offences is that the company is declared bankrupt.[44]

2.4.3 Criminal bankruptcy (*bancarotta semplice*)[45]

This criminal offence is committed when a director, with wilful misconduct or gross negligence:

(a) has wasted or contributed to waste a significant part of the company's assets in hazardous or openly irresponsible transactions;

(b) has carried out or contributed to carry out highly imprudent operations, with the intention to delay bankruptcy proceedings;

(c) 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;

(d) 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

(e) 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

(f) by committing any of the actions under (a) to (e) above, has contributed to worsen the financial conditions of the company by disregarding the duties specifically imposed on him by the law.

2.4.3.1 A person found liable of *bancarotta semplice* is sanctioned with imprisonment for six months to two years and disqualification from carrying on business activities and from holding executive office in any business enterprise for a period of up to two years. Further ancillary sanctions may apply, based on general criminal law rules.

2.4.4 Fraudulent bankruptcy (*bancarotta fraudolenta*)[46]

2.4.4.1 This criminal offence is committed when a director, with wilful misconduct or gross negligence:

(a) 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;

(b) 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;

(c) during the bankruptcy proceedings, has destroyed, concealed, or falsified the company's books and other accounting records;

(d) 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;

[43] For the criminal punishment of directors in case of incurrence in further debt by an insolvent enterprise, see paragraph 11.1.1.

[44] The same rules apply in the case of the so-called *concordato* preventivo (composition with creditors) 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).

[45] Articles 217 and 224, Bankruptcy Law.

[46] Articles 216 and 223, Bankruptcy Law.

(e) 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;[47] (ii) false corporate declarations causing damages to the company's shareholders or creditors;[48] (iii) unlawful refunds of capital contributions to shareholders;[49] (iv) unlawful distribution of profits and corporate reserves;[50] (v) transactions detrimental to the company's creditors;[51] (vi) formation of a fictitious share capital;[52] (vii) unlawful disposal of corporate assets;[53] or

(f) 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 punished by imprisonment for three to ten years – except for (d) above, as to which the term is one to five years – and disqualification from carrying on business activities and from holding executive office in any business enterprise for a period of ten years. Further ancillary 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 company or insolvency law 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 recapitalise or liquidate rule or those arising once an event of dissolution occurs (see paragraph 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 2003 company law reform, in light of a now-repealed rule under which directors were forbidden to "engage in new transactions" once an event of dissolution occurred, some courts held directors liable for any deficit accumulated after the occurrence of the event. Under the new regime (see paragraphs 2.3.2 and 2.3.3 above), directors will possibly be held liable for the whole deficit accumulated in connection with actions or omissions taken with purposes other than the preservation of the integrity and value of corporate assets. Based on the existing case law, it is not possible to assess 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.

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 trustee 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 paragraph 1.2.2 above 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 trustee:

(a) Non-executive directors may argue that harmful actions were taken by executive directors within the scope of their delegated power (see paragraph 2.2.1 above). 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 actions had occurred and whether they failed to do what was in their power to avoid or reduce the consequences.

(b) Statute of limitations (see paragraph 8.1).

(c) Absence of causal link between the violation and the damage suffered by the corporation and/or its creditors.

(d) Prompt expression of dissent to the harmful act (reported in the board minutes) and immediate written notice to the chairman of the board of statutory auditors.[54]

2.6.2 The courts have consistently held that, for the purpose of determining whether the directors are liable towards the company for certain harmful transactions, it is generally irrelevant whether such transactions have been previously authorised by the shareholders.

2.6.3 Neither criminal nor fraudulent bankruptcy felony is applicable to payments made and other transactions carried-out to implement a composition with creditors (*concordato* preventivo), a restructuring agreement (*accordo di ristrutturazione*) or a recovery plan (*piano attestato di risanamento*), or to payments and financing authorised by the court in the context of a *concordato* con continuità aziendale.[55]

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[47] Article 2621, Civil Code.
[48] Article 2622, Civil Code.
[49] Article 2626, Civil Code.
[50] Article 2627, Civil Code.
[51] Article 2628, Civil Code.
[52] Article 2632, Civil Code.
[53] Article 2634, Civil Code.
[54] Article 2392, Civil Code for SpA and, with minor differences, Article 2476, Civil Code for SRL.
[55] Articles 217-bis, Bankruptcy Law.

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 also be a member of the board of directors. General managers are liable to the corporation, its creditors and third parties under the same rules applicable to directors. Liability, however, only covers violations relating to the general managers' tasks as defined in the appointment resolution or in the by-laws.

3.1.2 Like directors (see paragraph 2.2.9 above), general managers may be held liable to shareholders and third parties according to general tort law principles.

3.1.3 Like directors (see paragraph 2.4 above), general managers may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.1.4 It is debatable whether other top officers shall be deemed subject to the liability regime applicable to general managers. However, in listed companies, the officer in charge of preparing the company's financial reports (*dirigente preposto alla redazione dei documenti contabili societari*), in relation to the duties and responsibilities entrusted to his office – essentially corresponding to those typically assigned to chief financial officers – is expressly subject to the same liability regime applicable to the members of the board of directors.[56]

3.2 Company liquidators

3.2.1 When a company is dissolved, the shareholders' meeting, or the court in case of inertia by the shareholders, appoints 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 degree of care and diligence required by the nature of their office. Rules on directors' liability equally apply to liquidators who have acted in breach of their duties.[57]

3.2.3 Like directors (see paragraph 2.4 above), liquidators may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.[58]

3.3 Members of the board of statutory auditors

3.3.1 The board of statutory auditors in companies who opted for the traditional corporate governance system has a duty to verify: (a) directors' and managers' compliance with the law, the by-laws and principles of correct management; and (b) the adequacy of the organisational, administrative and accounting arrangements adopted by the company and the actual operation thereof.

3.3.1.1 In closely-held SpA, which are not under an obligation to prepare consolidated financial statements, the by-laws may also entrust to the board of statutory auditors the auditing of the company's financial statements. In those SRL where the board of statutory auditors is mandatory, the board audits the company's financial statements, unless the by-laws provide otherwise.

3.3.2 Should the board of statutory 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.[59] It may call a shareholders' meeting and/or file a complaint with the court for material irregularities and/or – provided that two-thirds of the members approve the proposal – bring a derivative suit against the directors.[60] 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 statutory auditors) and must report to CONSOB any irregularities of which they become aware.[61]

3.3.3 The members of the board of statutory auditors must perform their duties with the degree of care and diligence required by the nature of their office. They are jointly and severally liable – together with the directors – *vis-à-vis* the company and/or its creditors for the directors' actions and omissions, if the damage would not have occurred had they complied with their duties.

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[56] Article 154-bis, Legislative Decree No. 58 of 25 February 1998.

[57] Article 2489, Civil Code.

[58] Article 2633, Civil Code specifically sanctions as *bancarotta fraudolenta* the unlawful distribution of corporate assets by liquidators.

[59] The members of the board of statutory auditors are under a duty to attend the board of directors and executive committees meetings (Article 2405, Civil Code) and they may at any time carry out inspections, also individually, and request information from the directors regarding the company's management (Article 2403-bis, Civil Code).

[60] Article 2393, paragraph 3, Civil Code.

[61] Articles 149, paragraph 3, and 151, paragraph 2, Legislative Decree No. 58 of 25 February 1998.

3.3.4 Bankruptcy trustees often sue members of the board of statutory auditors for damages according to the provisions described under paragraphs 3.3.1 to 3.3.3 above alleging that:

(a) they failed to exercise their powers to avoid or reduce the damage brought to the corporation and/or its creditors by directors' or managers' actions and omissions;

(b) the corporation and its creditors would have suffered no damage (or less damage) if the members of the board of statutory auditors had complied with their duties.

3.3.5 Although the law clearly requires the existence of a link between the statutory auditors' failure to comply with their duties and the damage incurred by the corporation and/or its creditors, courts tend to shift upon the defendants the burden of proving that the damage would not have been avoided or reduced if the statutory auditors had complied with their duties. Further, courts are usually strict in evaluating statutory auditors' conduct when directors continue running the company in violation of their duties under the recapitalise or liquidate rule or of provisions concerning the management of dissolved companies.

3.3.6 Like directors, members of the board of statutory auditors may be held liable to shareholders and third parties according to general tort law principles.

3.3.7 Like directors, statutory auditors may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.4 Members of the supervisory board

3.4.1 In companies with a two-tier governance system, the supervisory board performs auditing functions which are very similar, in terms of powers and duties, to those pertaining to the board of statutory auditors in the traditional governance system. There are, however, at least two relevant differences. On the one hand, the company's by-laws may not entrust the supervisory board with the audit of the company's financial statements, a task which always has to be performed by an external auditor, even in closely held corporations. On the other hand, the supervisory board appoints and removes the members of the management board.

3.4.2 According to the Civil Code, the members of the supervisory board must perform their duties with the degree of care and diligence required by the nature of their office and are jointly and severally liable – together with the members of the management board – *vis-à-vis* the company and/or its creditors for the damages caused by actions or omissions of the management board, if such damages would not have occurred if they had complied with their duties.[62]

3.4.3 If the by-laws also entrust the supervisory board with the power to resolve upon strategic transactions and industrial and financial plans drafted by the management board,[63] the members of the supervisory board, according to the prevailing interpretation, may be held directly liable *vis-à-vis* the company, its creditors and/or third parties for the damages resulting from such transactions. However, the members of the management board will remain in any case liable for actions they carry out for the implementation of such resolutions.

3.4.4 Liability to shareholders and third parties according to general tort law principles also applies to supervisory board members.

3.4.5 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 generally required to have their financial statements reviewed by external auditors; however the by-laws of closely-held SpA may entrust such review to the board of statutory 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;

(b) that companies' annual and consolidated financial statements correspond to the results of the accounting records and tests performed and that they comply with the relevant statutory and regulatory provisions.[64]

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 any irregularities to the board of statutory auditors and to CONSOB without delay.[65]

3.5.4 External auditors are liable *vis-à-vis* the corporation, its creditors and/or third parties for the damages occurred as a result of a breach of their duties.[66]

3.5.5 If the external auditor is a legal entity (as required in the case of listed corporations), 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 on a regular basis, 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 paragraph 2.4 above).

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[62] Article 2409-terdecies, paragraph 3, Civil Code.
[63] Article 2409-terdecies, paragraph 1, Civil Code.
[64] Article 2409-ter, Civil Code, and Article 155, Legislative Decree No. 58 of 25 February 1998.
[65] Article 155, Legislative Decree No. 58 of 25 February 1998.
[66] Article 2409-sexies, Civil Code, and Article 164, Legislative Decree No. 58 of 25 February 1998.

3.7 Sole shareholder

3.7.1 After the 2003 company law reform, the Civil Code provides that, in the event of insolvency, for obligations incurred during the period in which the capital of an SpA or SRL was held by a sole shareholder, such shareholder will be unlimitedly liable for the company's obligations if:[67]

(a) it has not fully paid its capital contributions upon subscription; or

(b) the directors or the sole shareholder omit to file with the Companies' Register a declaration identifying the sole shareholder.

3.7.2 According to decisions rendered by Italian courts prior to the 2003 company law reform, shares were deemed to be owned by a single shareholder only when it 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 can be confirmed under the new regime, meaning that a company with a "quasi-sole" shareholder who has not fully paid up its shares or who has omitted to declare that it is the sole shareholder may be held liable for its company's obligations.

3.7.3 According to the prevailing case law, the sole shareholder cannot itself be declared bankrupt as a consequence of its 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 paragraph 3.10.3 below) or, finally, under general tort law principles (see paragraph 3.11 below). 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.[68] However, such individuals will only be liable for debts incurred personally and in the exercise of such back-up business, as opposed to liabilities 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 paragraph 2.4), even in the absence of evidence that they were *de facto* directors of the insolvent company.

3.9 SRL shareholders resolving upon or authorising harmful transactions

3.9.1 With regard to SRL only, the 2003 company law reform introduced a substantial innovation in the area of shareholders' liability for management actions. According to this regime, the shareholders who wilfully resolved upon or authorised harmful transactions to the detriment of the company, its creditors and/or third parties may be held jointly and severally liable – together with the directors – for the damages resulting from such transactions.[69]

3.10 Groups of companies and the liability of parent companies and their directors

3.10.1 According to one of the most problematic provisions in the 2003 company law reform,[70] 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 liability regime applies to legal entities[71] with so-called "direction and coordination" powers over an Italian company.[72] The law does not set forth specific criteria for determining when an entity exercises *de facto* "direction and coordination" powers over a given company. However, according to the prevailing interpretation of the rule by commentators and by the fairly limited published case-law on this subject, an entity may be found to have "direction and coordination" powers over 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).[73] This legal framework also applies when an entity exercises direction and coordination powers over a company pursuant to ad-hoc agreements or by-laws provisions.[74]

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67 Article 2325, Civil Code.

68 Under Italian law, only companies and individuals exercising an unincorporated commercial (i.e., non-agricultural or professional) business may be declared insolvent.

69 Article 2476, paragraph 7, Civil Code. As noted by certain commentators, although this provision expressly applies only to limited liability companies, it cannot be entirely excluded that this rule may somehow be extended by the courts to corporations.

70 Article 2497, Civil Code.

71 The terms used by the law (le società o gli enti) are broad enough to encompass any person other than individuals.

72 Article 2497, Civil Code.

73 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."

74 Article 2497-septies, Civil Code.

3.10.2 Although the concept of control is not per se equivalent to the exercise of "direction and coordination" powers,[75] a parent entity is rebuttably presumed to exercise "direction and coordination" powers with respect to (a) any subsidiaries for which consolidation is compulsory,[76] and (b) any subsidiaries under its sole control.[77] To rebut this presumption, convincing evidence of appropriate management independence at the subsidiary company should be provided. If management decisions at the subsidiary's level are effectively independent from the parent entity's influence, this regime should arguably not apply.

3.10.3 A Directing Entity may be liable to minority shareholders and creditors of a Directed Company for abuse of "direction and coordination" powers.[78] In particular, a Directing Entity that, acting in its own interest or in the interest of third parties, mismanages a Directed Company, is liable:

(a) to the Directed Company's other shareholders for any ensuing damage affecting returns on, or the value of, their shareholdings; and

(b) 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.[79]

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 Further, under the Prodi Law, in the case of a group of companies, the directors of the parent company may be held jointly liable with the subsidiary's directors for the damages caused to the insolvent subsidiary by means of an abuse of direction powers within the group.[80]

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 (a) a wilful misconduct or gross negligence by the third party; (b) the damage caused to the company; and (c) a casual link between the two.

3.11.2 The loss may either be (a) general (i.e., suffered by the company, and therefore by all the creditors) in which case the bankruptcy trustee must bring the action or (b) specific to one creditor, in which case the action must be brought by the individual 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 paragraph 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 clawback 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.

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75 Art. 2497-sexies, Civil Code.

76 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 9 April 1991, implementing the 7th EC Company Law Directive. Consolidation of a jointly-controlled company is possible but not mandatory (see Article 37).

77 For these purposes, control is defined as (a) holding (directly or indirectly) more than 50% of the vote at a company's ordinary shareholders' meeting, (b) exercising a dominant influence at the company's ordinary shareholders' meeting through the (direct or indirect) exercise of voting rights, or (c) exercising a dominant influence on the company through contractual arrangements. See Article 2359, Civil Code.

78 Article 2497, Civil Code.

79 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).

80 Article 90, Legislative Decree No. 270 of 8 July 1999. Some commentators doubt whether this provision is still in force under the new regime of corporate groups, claiming that it should be regarded as implicitly repealed.

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 Transactions potentially subject to a clawback action

4.1.1 According to Italian Bankruptcy Law, under certain circumstances, the bankruptcy trustee may bring an action for the voidance of certain payments and transactions carried out by the company during the so-called preference period (*revocatoria fallimentare*). The purpose of such action is to reconstitute the company's assets in the interest of all creditors by unwinding certain transactions which (a) have been carried out to the detriment of the company or of creditors as a whole, or (b) are unfairly beneficial to a specific creditor, and thus violate the general principle of equal treatment of creditors (*par condicio creditorum*).

4.1.2 The Civil Code provides for a similar remedy, called ordinary clawback procedure (*revocatoria ordinaria*), whereby a creditor may challenge the transactions undertaken by its debtor – irrespective of its actual insolvency – which defraud the creditor's rights, even if such transactions are carried out before the preference period and subject only to the applicable statute of limitations (see the answers to question 8 below).

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 preference period (or even before) may be voided on the basis of the actions described hereof.

4.2 Summary of heads of challenge

4.2.1 Bankruptcy clawback procedure (*revocatoria fallimentare*)

4.2.1.1 The purpose of the bankruptcy clawback action – which was substantially amended by the 2005 Bankruptcy Law reform – is to unwind certain transactions carried out by a company to the detriment of the generality of its creditors.

4.2.1.2 Compared to other jurisdictions, Italian clawback rules have traditionally been considered extremely favourable to bankruptcy trustees. Prior to the 2005 Bankruptcy Law reform, payments and transactions, including those at arm's length, could be voided by the court upon request of the bankruptcy trustee, if made within one or two years prior to the bankruptcy declaration, depending on the circumstances. The 2005 reform (a) has shortened the statutory preference periods to six months and one year, respectively; (b) introduced additional criteria to establish when transactions may be voided as transactions outside the ordinary course of business; and (c) established certain exemptions from the clawback action.

4.2.1.3 The relevant preference period varies based on the specific transaction:

(a) certain actions which fall within the ordinary course of business (i.e., conveyances for adequate consideration, payments of due and payable debts, and granting of security interests upon contracting a debt)[81] may be voided if (i) they have been carried out within six months prior to the opening of the bankruptcy proceeding, and (ii) the bankruptcy trustee proves that the company's counterparty had actual knowledge of the company's insolvency at the time of the transaction[82] (but see paragraph 4.2.1.4 below for possible exemptions);

(b) certain actions which are outside the ordinary course of business (i.e., transactions for inadequate consideration, discharge of due and payable debts not made with cash or other normal means of payment, and pledges and mortgages granted for pre-existing debts not yet due and payable)[83] may be voided if they have been carried out within one year prior to the opening of the bankruptcy proceeding; the company's counterparty may avoid the clawback by proving that it was not aware of the debtor's insolvency at the time of the transaction;

(c) pledges and mortgages granted as security for due and payable debts may be voided if they have been granted within six months prior to the opening of the bankruptcy proceeding;[84] the company's counterparty may avoid the clawback by proving that it did not have actual knowledge of the debtor's insolvency at the time the security was granted.

4.2.1.4 One of the most important innovations of the recent Bankruptcy Law reforms was the introduction of certain exemptions from bankruptcy clawback.[85] Exempted transactions include the following:

(a) payment of goods and services made in the ordinary course of business on customary market terms and conditions;

(b) payment of salaries to employees;

[81] Article 67, paragraph 2, Bankruptcy Law.
[82] 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).
[83] Article 67, paragraph 1, Bankruptcy Law.
[84] Article 67, paragraph 1, Bankruptcy Law.
[85] Article 67, paragraph 3, Bankruptcy Law.

(c) transactions, payments, guarantees and security in the context of a court-supervised composition with creditors (*concordato* preventivo), a restructuring agreement ratified by the court (*accordo di ristrutturazione*) or a recovery plan assessed by the debtor's auditors (*piano attestato di risanamento*) and other transactions, payments, guarantees and security interests lawfully carried out or given after the filing of the application to access a *concordato* preventivo;

(d) bank remittances to the extent that they did not materially and durably decrease debtor's exposure towards the bank; and

(e) sale agreements (or preliminary agreements) of real estate properties used by the purchaser (or its close relatives) for residential purposes, provided that the agreed consideration was fair and the agreement was registered at the Land Registry.

4.2.1.5 Transactions without consideration and early repayments of debts with a maturity date falling on or after the date of the bankruptcy declaration have no effect *vis-à-vis* the creditors, if made within two years prior to the opening of the bankruptcy proceeding.[86]

4.2.1.6 The bankruptcy clawback action is also available in the case of *amministrazione straordinaria*, but only if the procedure involves a sale of corporate assets (liquidation purpose).[87] By contrast, the clawback is not available when the *amministrazione straordinaria* involves the implementation of a restructuring plan (recovery purpose).

4.2.2 Ordinary clawback procedure (*revocatoria ordinaria*)

4.2.2.1 Beside the specific bankruptcy clawback action available *vis-à-vis* bankrupt debtors, the Civil Code[88] grants creditors a general right to challenge transactions that defraud their rights. This remedy is available to any creditor, regardless of the actual status of insolvency of the debtor. However, once the bankruptcy proceeding has been opened, 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 (a) the existence of a damage to the creditor and (b) actual knowledge by the debtor and by the third party of the damage caused to the creditor. If the detrimental transaction occurred before the creditor's right arose, the plaintiff must provide evidence that such transaction was intentionally performed by the debtor – with the participation of the third party – to harm the creditor's rights. However, the *revocatoria ordinaria* can be quite a lengthy procedure and the burden of proof upon 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 statutory auditors and of the supervisory board, general managers, *de facto* directors, external auditors and liquidators may only be brought by the bankruptcy trustee[89] (or by the extraordinary commissioner in the *amministrazione straordinaria*). The same rule applies to actions against parent companies and their directors for damages suffered by the subsidiary's creditors.[90]

5.2 Actions against the sole shareholders (see paragraph 3.7) or to shareholders exercising a backup business (see paragraph 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 backup business, whereupon the action will pertain to the bankruptcy trustee.

5.3 In the event of bankruptcy of a Directed Company, the action inuring to the creditors as described above (see paragraph 3.10.3) can only be exercised by the bankruptcy trustee.[91]

5.4 With the exception of the action referred to under paragraph 5.3 above, even during insolvency proceedings, nothing prevents individual creditors and other third parties from suing directors and other persons (see question 3 above) 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 paragraph 3.11.2).

[86] Articles 64 and 65, Bankruptcy Law. Strictly speaking, these transactions and payments, rather than being subject to clawback, are ineffective by operation of law.
[87] Article 49, Legislative Decree No. 270 of 8 July 1999.
[88] Article 2901, Civil Code.
[89] Article 146, Bankruptcy Law.
[90] Article 2497, Civil Code.
[91] Ibidem, paragraph 4.

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 For causes of action outlined under paragraphs 2.1 - 2.3, 3.1 - 3.6, 3.9 - 3.12, liability is civil and extends only to actual damages with a causal link to the defendant's actions or omission, subject to the qualifications provided above. For causes of action described above under paragraphs 3.7 and 3.8, the shareholders are personally liable for the company's or the business' debt.

6.2 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.

6.3 Penalties for criminal bankruptcy and fraudulent bankruptcy have been described under paragraph 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.

6.4 No disgorgement of profit remedy is available under Italian civil law. By contrast, under criminal law, the court may order the forfeiture of the profits resulting from the crime.

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. Failure to do so could result in criminal liability (see paragraphs 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's directors.

7.3 Personal duties after the bankruptcy declaration

Once the company has been declared bankrupt, the directors and liquidators are subject to certain obligations. In particular, they must inform the bankruptcy trustee of any change to their residence or domicile. If information or clarifications are needed in connection with the bankruptcy procedure, the directors and liquidators, if so requested, must appear before the judge in charge of the bankruptcy proceeding, the bankruptcy trustee or the creditors' committee. In case of impediment or other justified reason, the judge in charge of the bankruptcy proceeding may authorise the director and liquidators to appoint an attorney-in-fact to appear on their behalf.[92]

7.4 Obligation to co-operate during the bankruptcy proceeding

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 Beside the general duties described under paragraph 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 criminal liability.[93]

[92] Articles 146 and 49, Bankruptcy Law.
[93] Articles 87 and 220, Bankruptcy Law.

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.

7.4.4 The general criminal law principle, according to which an indicted person has the right to remain silent during the prosecution,[94] also applies to the company directors charged with the crimes described under paragraph 2.4.

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 4 November 1950, the Convention), the provisions of which were incorporated into Law No. 848 of 4 August 1955.

7.5.2 The persons identified in the response to question 3 above 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:

(a) require that a particular provision of insolvency law is construed in accordance with such Convention Rights or otherwise declared incompatible; or

(b) 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:

(a) Article 6 – the right to a fair trial;

(b) Article 4 – prohibition of slavery and forced labour;

(c) Article 8 – the right to respect private and family life;

(d) Protocol 1, Article 1 – the 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

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:

(a) actions for damages against directors, statutory auditors, members of the supervisory board, 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;[95]

(b) actions for damages against directors, general managers, statutory auditors, 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,[96] 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;

(c) actions for damages against SRL directors and shareholders (paragraphs 2.2 and 3.9), is five years from the date when the damage has occurred.[97] However, if, as is usually the case, the damage occurs before directors leave office, the five-year period starts from the termination date;

(d) all actions for damages described under questions 2 or 3 above which are based upon tort law principles, is five years from the date of the harmful act or omission.[98]

[94] Article 64, Criminal Procedure Code.

[95] Articles 2393, 2396, 2407, 2489, Civil Code; Article 223-septies, Disposizioni di Attuazione del Codice Civile; Article 164, Legislative Decree No. 58 of 25 February 1998.

[96] Article 2949, Civil Code; Article 223-septies, Disposizioni di Attuazione del Codice Civile; Article 164, Legislative Decree No. 58 of 25 February 1998.

[97] Article 2949, Civil Code.

[98] Article 2947, Civil Code.

8.1.2 Sole shareholders are liable for the debts of their company in special circumstances (paragraph 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 hold that the liability of Directing Entities (see paragraph 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.

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 the earlier of three years from the date of the bankruptcy declaration and five years from the date of the challenged transaction.

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 appeal on the merits, and the decisions of the courts of appeal are subject to revision by the Supreme Court, but only on the basis of violation of law.

QUESTION 9

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.[99] Therefore, the liability actions described above and based upon company law provisions[100] may be brought against such entities' directors and other relevant persons.

9.1.1 As a general matter, it is doubtful whether, in light of the *Centros* case law,[101] the conflict of law rule described under paragraph 9.1 above would withstand scrutiny from the European Court of Justice with respect to companies incorporated in other EU jurisdictions.

9.2 According to international private law principles, Italian tort law applies if the harmful event has occurred in Italy.[102]

9.3 It is 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 application of such principles, then the rule described under paragraph 9.2 above should apply. If it is, instead, part of company law, then the rule described under paragraph 9.1 above 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 paragraph 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.[103] The Regulation also contains specific provisions for creditors' claims.

[99] Article 25, Law No. 218 of 31 May 1995.
[100] See paragraphs 2.2, 2.3, 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.7 and 3.9 above.
[101] 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).
[102] Article 62, Law No. 218 of 31 May 1995.
[103] Article 4, Regulation No. 1346/2000.

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 (a) the said act is subject to the law of a Member State other than that of the State of the opening of proceedings, and (b) such law does not allow any means of challenging that act in the relevant case.

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 materialise in Italy in the early nineties. In most 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 actions which are the consequence of gross negligence can be negotiated.

10.3 In light of the 2003 company law reform, it is debated which is the competent corporate body of the company that should 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. If provided by the by-laws, the general meeting may establish a cap for the aggregate remuneration of all directors, including those vested with special powers.

QUESTION 11

11. How safe is it for directors and others to incur further credit 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 specific circumstances 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 should not conclude that incurring further credit during the "twilight period" is per se likely to be sanctioned by Italian courts.

11.1.1 However, strict scrutiny will normally be adopted in considering transactions entered into when a company faces financial difficulties. Moreover, from a criminal law perspective, any directors, general managers and liquidators who incur or continue to incur further credit, concealing the status of insolvency of the company, will be punished by imprisonment from six months to three years.[104]

11.1.2 In consideration of the foregoing, directors and other officers must take an extremely prudent approach when considering the opportunity to incur further debt in the "twilight period" (in particular in circumstances where a court may deem the company already insolvent, as opposed to simply having financial troubles).

11.2 As noted in question 4 above, a number of transactions undertaken during the "twilight period" may be subject to bankruptcy clawback procedures. 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 caused to creditors by the transaction. 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 the situation.[105]

11.3 Finally, the new exemptions from bankruptcy clawback (see paragraph 4.2.1 above) are intended to protect certain categories (i.e., employees and purchasers of residential properties) and to incentivise the restructuring procedures introduced (or improved) by the Bankruptcy Law reforms. However, the introduction of the exemption for transactions carried out in the exercise of debtor's business at customary market terms will generally encourage the continuation of ordinary business relationships with enterprises that may be in financial distress (though not yet insolvent) and influence the overall approach taken by third parties dealing with such enterprises. However, since those new exemptions were introduced by the 2005 Bankruptcy Law reform, there is not yet any clear guidance from case-law on how the relevant criteria (in particular the reference to customary market terms) should be interpreted.

[104] Articles 218 and 225, Bankruptcy Law.

[105] In a number of cases, Italian courts have found that certain circumstances (such as acceleration of debt or systematic seizures of debtor's assets) may justify a presumption of knowledge of debtor's insolvency.

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 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?

In general, Japan's Bankruptcy Law has no clear period that can be labelled as the "twilight zone", as is sometimes found in other systems. The Bankruptcy Law was revised on 1 January 2005. In general, the changes were intended to bring uniformity between the Bankruptcy Law and the related Civil Rehabilitation Law and Corporate Reorganisation 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, with respect to the period preceding adjudication of bankruptcy, which the bankruptcy trustee may avoid by exercising the right of avoidance. The transactions which may be set aside include:

1.1 Avoidance of actions detrimental to creditors in bankruptcy

(i) Any act (except for an act which concerns furnishing security or extinguishing an obligation) done by a bankrupt with the knowledge that it would prejudice the creditors in bankruptcy may be avoided in favour of the bankrupt estate after the commencement of the bankruptcy procedure; provided that this shall not apply where the person who benefited did not know at the time of the act that it prejudiced the creditors in bankruptcy (Bankruptcy Law, Art 160, Sec 1, Para 1).

(ii) Any act done by a bankrupt subsequent to suspension of payment or an application for commencement of bankruptcy procedure, which prejudices the creditors in bankruptcy; provided that this shall not apply where the person who benefited did not know at the time of the act that there had been a suspension of payment etc. and that it prejudiced the creditors in bankruptcy (Bankruptcy Law, Art 160, Sec 1, Para 2).

1.2 Avoidance of acts disposing of property by obtaining the appropriate consideration

In the case where a bankrupt performs any act disposing of its own property, if it receives appropriate consideration from the other party, the act may still be avoided for the benefit of the bankrupt estate after the commencement of bankruptcy procedure, if certain requirements are satisfied (such as concealment and insiders) (Bankruptcy Law, Art 161).

1.3 Avoidance of furnishing of security etc. against certain creditors

Any action mentioned in the following list limited to actions concerned with the furnishing of security or the extinguishing of an obligation may be avoided for the benefit of a bankrupt estate after the commencement of bankruptcy procedure:

1.3.1 Any action performed by a bankrupt after it fails to make payment or after the commencement of the bankruptcy procedure is applied for, provided that this shall only apply where the creditor knew at the time of such action that (i) or (ii) applied, as appropriate:

(i) where the said action was performed after the failure to make payment: that there had been a failure to make payment or suspension of payment;

(ii) where the said action was performed after the commencement of bankruptcy procedure had been applied for: that the commencement of bankruptcy procedure had been applied for;

1.3.2 Any action not related to the obligation of a bankrupt or the timing of which is not related to the obligation of a bankrupt, and which was performed during the 30 days prior to the date when the failure to pay arose; provided that this shall not apply where the creditor did not know at the time of the action that it prejudiced other creditors in bankruptcy (Bankruptcy Law, Art 162, Sec 1,2).

1.4 Any gratuitous act and any act performed for consideration which is deemed equivalent to a gratuitous act, which was done by a bankrupt after the suspension of payment etc. or within six months prior to the suspension of payment, may be avoided for the benefit of a bankrupt estate after the commencement of bankruptcy procedure (Bankruptcy Law, Art 160, Sec 3).

1.5 Limitation of avoidance which requires suspension of payment

Any action done more than one year from the date of application for commencement of bankruptcy procedure (except for the action provided in Article 160 paragraph 3 of the Bankruptcy Law) shall not be avoided on the ground that the action was done after the suspension of payment or that the fact of suspension of payment had been known (Bankruptcy Law, Art 166).

In the application of the right of avoidance, the requirements for the relevant period are usually left to interpretation due to the absence of statutory provisions, with the exception of those described above, though there may be wide distance between the article of right of avoidance and penal provisions (see further below). In bankruptcy trustee practice, the avoidance of transactions is more likely to be upheld by the court if the underlying transaction occurred within the period of around three months immediately preceding the suspension of payment or the filing of the bankruptcy petition. Although the statutory language creating the one year limit described above is specific to certain situations, transactions beyond one year are rarely, if ever, avoided in practice.

Chapter XIV of the Bankruptcy Law consists of penal provisions to be applied specifically for crimes related to bankruptcy, including in respect of the actions of directors and managers (Bankruptcy Law, Arts 265, 266, 268, 269, 270, 271, 272, 273, 274 and 275). The Bankruptcy Law provides for the civil liability of directors and statutory auditors of a bankrupt and 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 of their own accord. In conjunction with the commencement of such an action, the trustee may ask for, or the court may apply, a provisional attachment on the defendant director's (officer's) assets.

No penal provision of the Bankruptcy Law applies exclusively to the period covered by the right of avoidance although, in practice, potentially 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:

1.6 Offence of fraudulent bankruptcy

(1) If any person performs any action falling within any of the following categories either prior to or subsequent to the commencement of bankruptcy procedure for the purpose of injuring creditors, and if the ruling for commencement of bankruptcy procedure against the debtor has become final and conclusive, that person shall be sentenced to either imprisonment with labour not exceeding ten years or a fine not exceeding ten million yen, or both cumulatively. The same shall apply to a person who becomes the other party to the act mentioned in item iv with knowledge of the circumstances, when the ruling for commencement of bankruptcy procedure has become final and conclusive:

(i) concealing or destroying property of the debtor;

(ii) falsely indicating the transfer of property of the debtor or the owing of an obligation for the property;

(iii) modifying the status of property of the debtor and reducing the price for it; or

(iv) disposing of property of the debtor to the disadvantage of creditors (Bankruptcy Law, Art 265, Sec 1).

(2) In addition, the provisions in the preceding paragraph also apply to any person who has recognised that the ruling for commencement of bankruptcy procedure or the order of preservative administration is rendered against the debtor and who acquires property of the debtor or makes a third party acquire property for the purpose of injuring creditors and without approval of the bankruptcy trustee or for any other justifiable reason (Bankruptcy Law, Art 265, Sec 2).

1.7 Offence of furnishing of security to a specific creditor etc.

If, either prior to or subsequent to the commencement of bankruptcy procedure, in respect of an obligation owed to a specific creditor, for the purpose of injuring the other creditors, the debtor (in the case of bankruptcy of the inherited property, an heir, administrator of the inherited property or executor shall be included, and in the case of bankruptcy of the trust property, the trustee, etc. shall be included; hereinafter the same shall apply in this Article) performs an action related to the furnishing of security or the extinguishing of an obligation which is not an obligation of the debtor and if the ruling for commencement of bankruptcy procedure has become final and conclusive, such person shall be sentenced to either imprisonment with labour not exceeding five years or a fine not exceeding five million yen, or both cumulatively (Bankruptcy Law, Art 266).

1.8 Besides the Bankruptcy Law, the Japanese Companies Law provides for both criminal and civil liabilities that are relevant to this discussion.

Under the crime of Special Misappropriation, any director, officer, or other member of management of a company that, in breach of their duties, acts to benefit themselves or third persons, or to inflict damage on the company, and actually causes proprietary damage to the company, is liable to imprisonment not exceeding ten years or a fine in an amount not exceeding ten million yen (Companies Law, Art 960, Sec 1). Any attempt to commit this crime is also subject to punishment (Companies Law, Art 962).

Directors are jointly and severally liable to the company for the amount of damages incurred by the company as the result of their failure to duly perform their duties (breach of duty) (Companies Law, Art 423, Sec1 and Art 430). This liability may be limited for acts taken in good faith and in the absence of gross negligence (Companies Law, Art 425, Sec 1).

Directors are jointly and severally liable to third parties for damages caused by their intentional act or gross negligence in the performance of duties (Companies Law, Art 429, Sec 1).

In practice, criminal charges based on the penal provisions of the Bankruptcy Law are rarely investigated. Charges are more often brought under the Companies Law and other laws.

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 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 differences, if any, will be available in relation to each offense?

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 damage the other party to the transaction. Directors' conduct sometimes may be 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. Apart from civil liability under law, in Japan, representative directors of small and medium-sized companies usually personally guarantee certain of the companies' debts, such that the directors are contractually liable as co-signatories of each loan. Therefore, in practice, upon the company's bankruptcy, the representative director often becomes personally insolvent, making any additional civil liabilities moot. However, in larger companies, where the management lies with a broader board of directors, a personal guarantee by 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.

2.2.1 The civil liability incurred by a director to compensate for damage is based on the provisions of the Companies Law and the Bankruptcy Law. The latter is supposed to be pursued by a bankruptcy trustee. Directors' liability under the Companies Law is classified roughly into liability to the corporation and liability to a third party. A director is liable for all the actual damage incurred by a company (Companies Law, Art 423, Sec 1). In addition, a director is liable for actual damage to a third party for damages suffered by the creditor concerned (Companies Law, Art 429). Provisions under the Companies Law (Art 429) 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.

2.2.2 A director attends meetings of the board of directors and signs board minutes of the board's resolutions, so all directors who do not raise objections and have them noted are presumed to have approved the resolutions and 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.

2.2.3 Each director's liability must be investigated under the Companies Law, and under the Bankruptcy Law if the company finally goes bankrupt. However, there is no requirement regarding the period in which the person may claim against directors except for the prescription issue. The statute of limitations for these claims under the Civil Code and Companies Law has been held to be ten years by court precedent.

2.2.4 Of all the acts mentioned above, with respect to those acts relating to the right of avoidance, it is a 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 cease trading. 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 Companies Law is, basically, a liability imposed on directors and statutory auditors. However, there is judicial precedent that affirms the existence of a third party liability, based on Article 429 of the Companies Law, 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. Under the Companies Law 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 is supposed to be limited almost only to directors and statutory auditors, and in those companies that have adopted a structure with committees, 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 2.2.1 above.

QUESTION 4

4. Counterparts 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 In terms of the "twilight period", the factor given the most weight in terms of whether a transaction can be voided is whether one or both parties to the transaction knew the company had debt in excess of its assets or knew of a failure to make payment. In addition, apart from transactions subject to being voided as discussed in the answer to Question 1 above, the bankruptcy trustee must review all existing incomplete bilateral contracts to which the company is a party, and has the option of voiding remaining portions of the contract (Bankruptcy Law, Art 53).

4.2 Defences against challenges to transactions that take place during the "twilight period" are limited and are based primarily on the counterparty's knowledge of the company's state of insolvency. In addition, if the bankruptcy trustee makes a decision subject to the option above, the counterparty may not reject it. Where prior knowledge is clear, in general there is little defence against avoidance.

QUESTION 5

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 Companies Law, the public prosecutor has sole standing to take legal action against directors and others included in Question 3 above.

In a bankruptcy proceeding, with respect to a director's civil liability to the company originally based on Article 423 of the Companies Law, the bankruptcy trustee has standing to bring a suit. Prior to the commencement of the bankruptcy proceeding, this authority belongs to the statutory auditor of the company. In legal theory, even if the bankruptcy trustee (or the statutory auditor) takes no legal action, the shareholders may not bring a derivative suit. With respect to third party liability based on Article 429 of the Companies Act, a creditor that suffered damage has standing to sue. However, where all creditors similarly suffered loss, conflict between the bankruptcy trustee and all creditors may occur. This problem is left open to some interpretation given the absence of a clear statutory provision.

QUESTION 6

6. Remedies: orders available to the domestic court

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

There are no specific remedies other than the award of damages resulting from a civil suit, as described in the answers to Questions 1 to 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 and executive officer) is obliged to provide an explanation of the bankruptcy upon demand by the bankruptcy trustee or by the meeting of creditors (Bankruptcy Law, Art 40). Failure to abide by this requirement is a criminal offence, which is punishable by imprisonment not exceeding one year or a fine of no more than three million yen (Bankruptcy Law, Art 268, Sec 1). This duty obliges directors to provide all information necessary to preserve the assets of the company and to enable the bankruptcy trustee to otherwise perform its duties. In addition, where a representative director is personally insolvent and has filed for bankruptcy, for their lack of co-operation in explaining the company's bankruptcy may be deemed a reason to withhold the discharge from their own debts in their personal bankruptcy proceedings (Bankruptcy Law, 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 offenses identified in question 2.

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

8.1 With respect to the period to exercise the right of avoidance, the bankruptcy trustee may not exercise this right after two years have elapsed since the date of commencement of the bankruptcy procedure or when 20 years have elapsed from the date of the action (Bankruptcy Law, Art 176). With respect to civil liabilities, 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 Companies Law, the courts in Japan have generally held that civil liability under the Companies Law should follow liability under the Civil Code. The statute of limitations for criminal liability varies depending on the particular law. For the crime of Special Misappropriation under the Companies Law, the statute of limitations is seven years from the illegal activity. Under the Bankruptcy Law, the statute of limitations is seven years from the illegal activity for the crime of Fraudulent Bankruptcy, whereas the statute of limitations is five years from the illegal activity for the crime of furnishing security to a specific creditor etc. However, in practice, enforcement of the two criminal provisions under the Bankruptcy Law is rare. Furthermore, although the statutes of limitations are seven and five years respectively, in practice the enforcement of these laws would require the participation of the bankruptcy trustee, whose tenure typically lasts from one to, at most, three years. If a criminal investigation by the 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 in this chapter. 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

9. Foreign corporations

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

Under the Bankruptcy Law, foreign persons and corporations have the same status for bankruptcy purposes as Japanese nationals and Japanese corporations (Bankruptcy Law, Art 3).

QUESTION 10

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?

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. 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?

Under Japan's bankruptcy procedure, a bankruptcy trustee is appointed at the time of the commencement of the bankruptcy procedure. 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 the fiduciary duties owed to the company as well as whether taking on additional credit increases the risk of liability. Whether incurring the proposed credit can be deemed necessary to the company is also pertinent. If the proposed additional credit is determined to be necessary in the normal course of business, then the board of directors and/or executive officers have a duty to incur such credit for the purpose of proper management. 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, they will already personally guarantee much of the company's debt. In the "twilight 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 in this chapter, it is very unlikely that the director would incur any additional liability, other than contractual liability, from his or her decision that the company should incur additional credit. However, a 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 of prior knowledge without the transaction becoming subject to avoidance may be difficult.

MALAYSIA

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 The twilight period will commence once the company is insolvent and continues until the commencement of the liquidation (presentation of a winding up petition in the case of compulsory liquidation and the passing of a resolution to wind up in the case of voluntary liquidation).[1]

1.1.2 There are two categories of insolvency.

1.1.3 The first category concerns actual insolvency. The question is whether the company was 'insolvent' at the time (or as a result) of the relevant transaction. A company is insolvent when it is unable to pay its debts. There are three tests of a company's inability to pay its debts.[2] They are:

(i) the "commercial insolvency" test - a company is insolvent when it is unable to pay debts as and when they fall due. A company may wind up an asset rich but cash strapped company on account of deemed insolvency;[3]

(ii) unsatisfied execution process - clearly if execution or other process issued on a judgment is returned unsatisfied in whole or in part, it means that the company does not have cash and sufficient assets or assets of sufficient value which may be realised by judicial process to satisfy the judgment debt;[4] and

(iii) the "overall assets and liability" test - a petitioner may prove to the satisfaction of the court by positive evidence that the company is unable to pay its debts because the company's liabilities exceed the value of its assets. In this respect, the court shall take into account the contingent and prospective liabilities of the company.[5]

1.1.4 For this category of insolvency, a range of 'clawback' provisions apply (see para 1.2 below), which will affect transactions entered into by the company.

1.1.5 The second category concerns the concept of 'insolvent trading' where the law identifies the time at which a director had no reasonable or probable ground of expectation of the company being able to pay the debt. A director who continues to trade or incur liability in such circumstances will be personally liable unless he can show that he had a reasonable or probable ground to believe that the company was able to pay the debt.

1 Section 219 of the Companies Act 1965 (CA).

2 Loh Siew Cheang in Corporate Powers Accountability (2nd Edition). CA 1965 does not set out or define when a company is insolvent but merely provides the various circumstances in which the court may order the winding up of the company; section 218 of CA 1965. There is nothing in CA 1965 to say that the three different means of proof are exhaustive or exclusive of other kinds of evidence to prove inability to pay debts under section 218(1)(e) of CA 1965. Additionally, petitioners are not restricted to and need not limit the means available to them under section 218(2) of CA 1965 to prove their case; *Weng Wah Construction Co Sdn Bhd v Yik Foong Development Sdn Bhd* [1994] 2 MLJ 266.

3 Section 218(2)(a) of CA 1965: *Sri Hartamas Development Sdn Bhd v MBf Finance Bhd* [1992] 1 MLJ 313; *Datuk Mohd Sari bin Datuk Hj Nuar v Idris Hydraulics (M) Bhd* [1997] 5 MLJ 377; *Mlalayan Plant Pte Ltd v Moscow Narodny Bank Ltd* 1980] 2 MLJ 53.

4 Section 218(2)(b) of CA 1965 – a company is deemed to be insolvent if 'execution or other process issued on a judgment' is 'returned unsatisfied in whole or in part'.

5 Section 218(2)(c) of CA 1965.

1.1.6 The obligations of the directors of a company will 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 generally breaches of duty by the directors.[6]

1.1.7 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. Therefore, where a company is insolvent, the directors owe their duties to take into account the interests of the creditors. In this circumstance, the shareholders do not have the power or authority to absolve the directors from that breach.[7] However, this does not, in the absence of any conferral of such right by statute, confer upon creditors any general law right against former directors of the company to recover loss suffered by those creditors.[8]

1.2 Vulnerable periods

1.2.1 The winding up of a company is deemed to commence at the time of the presentation of the petition for the winding up.[9] The various clawback periods under CA 1965 are:

(a) sale at an undervalue or acquisition at an overvalue - two years prior to the commencement of winding up (section 295);

(b) undue preferences - six months prior to the commencement of winding up (section 293); and

(c) invalid floating charges - six months prior to the commencement of winding up (section 294).

1.2.2 In addition, section 223 of CA 1965 also provides that any dispositions made after the commencement of the winding up by the court shall, unless the court otherwise orders, be void.

1.2.3 CA 1965 confers on a provisional liquidator power to exercise all functions and powers of a liquidator subject to certain prescribed limitations and restrictions or as specified by the court in the order appointing him.[10] However, there are certain actions which can only be initiated by a liquidator; for instance transactions which will be affected by the clawback provisions (see para 1.2). A provisional liquidator may not initiate actions to set aside such transactions which will be affected by the clawback provisions because he is appointed by the court after the presentation of a winding up petition and before the making of a winding up order. In reality, a winding up order as against a company in provisional liquidation may or may not be granted.

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 acts 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 Insolvent trading[11]

(a) (i) In the course of winding up or any other proceedings against a company where it appears that an officer of the company who was knowingly a party to the contracting of a debt had, at the time of contracting, no reasonable or probable ground of expectation of the company being able to pay the debt, the officer commits an offence.

(ii) Proof of reasonable ground of expectation is judged by the standards of a director or manager of ordinary competence.[12]

(b) (i) Liability is criminal and civil. A person guilty of this offence is liable to imprisonment for one year or a RM5,000.00 fine.

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6 *Gilbert Engineering Co Inc v Zainuddin Ahmad & Ors* [2001] 7 CLJ 489 where Vincent Ng J held that directors generally do not owe a fiduciary duty to the company’s creditors.
7 *Kinsela v Russell Kinsela Pty Limited* (In Liq) [1986] 4 NSWLR 722.
8 *Sycotex Pty Ltd v Baseler & Ors* [1994] 12 ACLC 494.
9 Section 219(2) of CA 1965.
10 Section 231 of CA 1965.
11 Section 303(3) of CA 1965.
12 *3M Australia Pty Ltd v Kemish* [1986] 4 ACLC 185.

(ii) Section 304(2) of CA 1965 provides that where a person is convicted of insolvent trading, the court may declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt. Personal liability under this section is dependent on a conviction being obtained under section 303(3) of CA 1965. The court also has powers to make consequential orders to give effect to the declaration.[13]

(iii) The court has wide discretion to determine the extent of liability.

(iv) There is no specified period.

(v) The defence to this offence is that the director or officer at the time of contracting of a debt had a reasonable or probable ground of expectation of the company being able to pay the debt.

2.2 Fraudulent trading[14]

(a) Where it appears that any business of the company had been "carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose", the court may if it thinks proper to do so, declare that any person who was knowingly a party to the carrying on of the business in that manner is to be personally responsible without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.[15] The application for such declaration may be made by the liquidator or any creditor or contributory of the company. The elements of the offence are as follows:

(i) This section is not restricted to winding up proceedings against the company and could apply even prior to the winding up of a company. It applies where the company is in the course of winding up or where there are other proceedings against the company.[16]

(ii) Fraud and fraudulent purpose connote actual dishonesty involving, according to current notions of unfair trading among commercial men, real moral blame in relation to the expected standard of an ordinary and honest people.[17] The test applicable is whether the party concerned was fulfilling his role of "The Reasonable Expectations of an Honest Businessman".[18] "Defraud" requires a person (natural or corporate) as its object. An accused is guilty of fraud if he intends by deceit to induce a person to act in a way that puts that person's economic interests in jeopardy, even though he does not intend that he should ultimately suffer loss.

(iii) The scope of liability for "fraudulent trading" is wider than "insolvent trading" as the former applies to "any person who was knowingly a party" whilst the latter is confined only to "officers of the company".

(iv) In theory, it could be wide enough to catch a financier who funded the fraudulent trading knowing that it was being done dishonestly.

(v) It is not necessary in order to establish an offence to show that creditors were in fact defrauded.[19] An intention to defraud is sufficient. An intent to defraud is an intent to deprive creditors, or some creditors, of an economic advantage or inflict upon them some economic loss.[20]

(b) (i) Liability may be criminal or civil. A person guilty of this offence is liable to imprisonment for three years or a RM10,000.00 fine.

(ii) The court has a wide discretion to order compensation for the loss caused to the company by the director's conduct. While declarations under section 304(2) of CA 1965 refer only to personal liability for that particular debt, under section 304(1), personal liability may be for all the company's liabilities. Creditors benefit because the insolvent company is then in a better position to pay its debts. The court also has powers to make consequential orders.[21]

(iii) The court has wide discretion to determine the extent of liability.

(iv) There is no specified period.

The defence is that the party concerned was not dishonest and that he had no intention to defraud creditors. As long as he honestly believed that the new debt incurred would ultimately be repaid in full, he may not be found liable.

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13 Section 304(3) of CA 1965.
14 Section 304 of CA 1965.
15 Section 304(1) of CA 1965.
16 *Tang Eng Iron Works Co. Ltd v Ting Ling Kiew & Anor* [1990] 3 CLJ (Rep) 211.
17 *H. Rosen Engineering B.V. v Siow Yoon Keong* [1997] 1 CLJ 137. In H. Rosen's case, the High Court considered the word "fraud" and stated that *"The term 'fraud' has a distinctive meaning given in the Concise Oxford Dictionary - 9th Edn. as "the use of false representation to gain an unjust advantage; a dishonest artifice or trick; a person not fulfilling what is expected of him/her". "Fraudulent Purpose" - achieving by fraud; or dishonestly."*
18 In *H. Rosen Engineering B.V. v Siow Yoon Keong* [1997] 1 CLJ 137 it was stated that *"keeping in mind that 'honesty is the best policy' the defendant was expected to live to the standards to be observed by honest businessmen and not of an unconscionable conduct contrary to good conscience. The law of equity and good conscience is to be the order to be adopted in such commercial transactions to make good the resulting loss to an innocent person whose trust in the defendant has been betrayed by his misconduct."*
19 Section 304(5) of CA 1965.
20 *Coleman v The Queen* [1987] 5 ACLC 766. In *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569, the Court of Appeal held that the usual standard of proof for fraud in civil proceedings is beyond reasonable doubt, as laid down in *Yong Tim v Hoo Kok Chong & Anor* [2005] 3 CLJ 229. However, section 304(1) only uses the term *'if it appears'* which indicates a lower degree of proof.
21 Section 304(3) of CA 1965.

2.3 Offences by officers of companies in liquidation

2.3.1 Misconduct in the course of company being wound up[22]

(a) Personal liability will attach to a past or present officer of the company who:

(i) 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, 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 course of business;[23]

(ii) does not deliver up to the liquidator all the movable and immovable property of the company (including all books and papers) in his custody or under his control and which he is required by law to deliver up;[24]

(iii) knowing or believing that a false debt has been proved by any person fails for a period of one month to inform the liquidator;[25] or

(iv) prevents the production of any book or paper affecting or relating to the property or affairs of the company;[26]

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM5,000.00 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered.

(ii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iv) The offences must have taken place when a company is being wound up.

Absence of intention to defraud is a defence to a charge under 2.3.1(a)(i) or (ii) above and absence of intent to conceal the state of affairs of the company or to defeat the law is a defence to a charge under 2.3.1(a)(iv) above.

2.3.2 Fraud in the course of company being wound up[27]

(a) A past or present officer of the company commits an offence if he has:

(i) concealed any part of the property of the company to the value of RM50.00 or upwards, or has concealed any debt due to or from the company;[28]

(ii) fraudulently removed any part of the property of the company to the value of RM50.00 or upwards; [29]

(iii) concealed, destroyed, mutilated, falsified or has been privy to the concealment, destruction, mutilation or falsification of any book or paper affecting or relating to the property or affairs of the company;[30]

(iv) made or has been privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company;[31]

(v) fraudulently parted with, altered or made any omission in, or has been privy to fraudulent parting with, altering or making any omission in, any document affecting or relating to the property or affairs of the company;[32]

(vi) by any false representation or other fraud, has obtained any property for or on behalf of the company on credit which the company has not subsequently paid for;[33]

(vii) obtained on credit, for or on behalf of the company, under the false pretence that the company is carrying on its business in any property which the company has not subsequently paid for;[34]

(viii) pawned, pledged or disposed of any property of any company which has been obtained on credit and has not been fully paid for unless the pawning, pledging or disposing was in the ordinary way of the business of the company;[35] or

(ix) attempted to account for any part of the property of the company by fictitious losses or expenses.[36]

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM5,000.00 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered.

(ii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

[22] Section 300 of CA 1965.
[23] Section 300(1)(a) of CA 1965.
[24] Sections 300(1)(b)(i) and (ii) of CA 1965.
[25] Section 300(1)(e) of CA 1965.
[26] Section 300(1)(f) of CA 1965.
[27] Section 300(1)(c) of CA 1965.
[28] Section 300(1)(c)(i) of CA 1965.
[29] Section 300(1)(c)(ii) of CA 1965.
[30] Section 300(1)(c)(iii) of CA 1965.
[31] Section 300(1)(c)(iv) of CA 1965.
[32] Section 300(1)(c)(v) of CA 1965.
[33] Section 300(1)(c)(vi) of CA 1965.
[34] Section 300(1)(c)(vii) of CA 1965.
[35] Section 300(1)(c)(viii) of CA 1965.
[36] Section 300(1)(g) of CA 1965.

(iii) 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:

(1) within the twelve months prior to the commencement of the winding up, or

(2) at any time after the commencement of the winding up.[37]

(v) Absence of intention to defraud is a defence to a charge under 2.3.2(a)(i), (vii) or (viii) above and absence of intent to conceal the state of affairs of the company or to defeat the law is a defence to a charge under 2.3.2(a)(iii) or (iv) above.

2.4 Falsification of books[38]

(a) Every officer of any company being wound up commits an offence if 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 or book of account or document belonging to the company with intent to defraud or deceive any person.

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for five years or a RM30,000.00 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered.

(ii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iv) This offence applies when a company is being wound up.

(v) Absence of intent to defraud or deceive is a defence to this charge.

2.5 False representations to creditors[39]

(a) Any past or present officer of the company commits an offence if he makes any false representation or acts fraudulently 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.

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM5,000.00 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered.

(ii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iv) This offence applies to false representations made when a company is being wound up.

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.

2.6 Material omissions from statement relating to company's affairs[40]

(a) A past or present officer of a company commits an offence if he makes any material omission in any statement relating to the affairs of the company.

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM5,000.00 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered.

(ii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iv) This offence applies to statements made when a company is being wound up.

(v) Absence of intent to defraud is a defence to this charge.

2.7 Misfeasance[41]

(a) (i) Any person who has taken part in the formation or promotion of the company or past or present liquidator or officer of the company who has misapplied or retained or become liable or accountable for any money or property of the company may be examined by the court.

(ii) The court may do the same where such parties are guilty of any misfeasance or breach of trust or duty in relation to the company. The application to the court for such examination may be made by the liquidator or any of the company's creditors or contributories.[42]

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[37] Section 300(1)(c) of CA 1965.
[38] Section 302 of CA 1965.
[39] Section 300(1)(h) of CA 1965.
[40] Section 300(1)(d) of CA 1965.
[41] Section 305 of CA 1965.
[42] Section 305(1) of CA 1965.

(iii) In the case of an officer of the company, the court's power extends to and applies in respect of the receipt of any money or property by any officer of the company during the two years preceding the commencement of the winding up whether by way of salary or otherwise appearing to the court to be unfair or unjust to other members of the company.[43]

(b) (i) Liability is civil.

(ii) The court may order the 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 misapplication, retainer, misfeasance or breach of trust or duty as the court thinks just.

(iii) The court has wide discretion in relation to the making of orders under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.

(iv) Apart from the offence in respect of the receipt of any money or property by an officer of the company (during the two years preceding the commencement of the winding up), there is no time period within which the impugned acts must have occurred in order for liability to attach.

(v) It shall be a defence if the director in default can show that he has acted honestly and reasonably and the court concludes that he ought fairly to be excused.

2.8 Proper accounts not kept[44]

(a) (i) This offence applies where it is shown that proper books of account were not kept by the company for the period of two years immediately preceding the commencement of the investigation or winding up. The liability is on each officer who is in default.

(ii) Proper books of account shall be deemed not to have been kept in the case of any company if there have not been kept such books or accounts as are necessary to exhibit and explain the transactions and financial position of the trade or business of the company, or if the books or accounts have not been kept in such manner as to enable them to be conveniently and properly audited, whether or not the company has appointed an auditor.

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for three years or RM10,000.00 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered.

(ii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iii) In exercising its punitive jurisdiction under this section the court is not seeking to compensate the company.

(iv) The act in question must have occurred throughout the period of two years immediately preceding the commencement of the investigation or winding up or the period between the incorporation of the company and the commencement of the investigation or winding up (whichever is lesser).[45]

(v) It shall be a defence if the director in default can show that he acted honestly and that in the circumstances in which the business of the company was carried on, the default was excusable.

2.9 General duties of a director

(a) (i) The general duties of a director are codified in section 132 of CA 1965, which states that a director of a company shall at all times exercise his powers for a proper purpose and in good faith in the best interest of the company. These statutory duties largely restate the fiduciary duties under the general law. As long as the company is solvent, the interests of the company are the interests of its shareholders. However, the company's creditors' interests become increasingly important when the company is in financial difficulties.

(ii) The fiduciary duties of directors include:

- duty to act bona fide in the interests of the company;
- duty to act for their proper purpose;
- duty to retain their discretionary powers;
- duty to avoid conflicts of interest and duty;
- duty to disclose interests in contracts at general law; and
- duty not to make secret profits.

(iii) The statutory duties above operate in addition to any general law duties.[46] The main duties are set out in further detail below.

(b) (i) Liability 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.

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[43] Section 305(2) of CA 1965.
[44] Section 303 of CA 1965.
[45] Section 303(1) of CA 1965.
[46] Section 132(5) of CA 1965.

(iii) Liability for all 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.

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

(v) - There is no breach where a director acts in what he honestly believes to be in the interests of the company. The court is generally reluctant to override the business judgment of directors. A director is presumed to have acted bona fide for the benefit of his company and persons alleging a breach of duty bear the onus of proving that he has not acted bona fide.[47]

- A director of a company is only expected to exercise reasonable care, skill and diligence with the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities and any additional knowledge, skill and experience which the director in fact has.[48]

2.10 Duty to act bona fide in the interests of the company

2.10.1 Section 132(1) of CA 1965 requires a director to exercise his powers for a proper purpose and in good faith in the best interest of the company at all times. This provision corresponds with section 181(1) of the Corporations Act 2001 of Australia (Australian Act).

Good Faith

2.10.2 This duty is two-pronged in that it imposes a duty on the director to act “in good faith” and “in the best interest of the company”. The requirements of the duty to act in good faith are that the director must:

- exercise his powers in the interest of the company;
- not misuse or abuse his power;
- avoid conflict between his personal interests and those of the company;
- not take advantage of his position to make secret profits; and
- not misappropriate the company’s assets for himself.[49]

2.10.3 The test as to whether or not a director has acted in the best interest of the company is a subjective one. A director must act bona fide in what he considers - and not what the court may consider - is in the best interest of the company. This test precludes the court from second guessing the commercial decisions of the director as to where the best interest of the company lies.[50]

2.10.4 A director’s primary duty is to act in the interests of the company of which he is a director. The proper test in the absence of evidence of the subjective state of mind of the director is whether ‘an honest and intelligent man in the position of the directors, taking an objective view, could reasonably have concluded that the transactions were in the interests of the company’. If the court concludes that an honest and intelligent person could have reasonably concluded that the transactions were in the interests of the company, there is no breach of fiduciary duty.[51]

2.11 Duty to exercise powers for proper purposes

2.11.1 The requirement to act for a proper purpose is distinct from the requirement that the directors act bona fide. The test is whether the director’s actions had been taken in accordance with the purpose for which it was intended and was exercised for the benefit of the company. A director may therefore still breach this duty even if he honestly believes his actions are in the best interests of the company as a whole. The court will first examine the power which the director had exercised to determine the purpose for which the power was granted. Then, the court will determine the substantial purpose for which the power was in fact exercised to determine if the power was exercised honestly and in the interest of the company.[52]

2.11.2 The onus of establishing that a director had acted in breach of such duty is on those alleging the breach.

2.12 Duty to act with reasonable care, skill and diligence

2.12.1 Section 132(1A) of CA 1965 provides a partly subjective and partly objective test for reasonable care, skill and diligence:

“A director of a company shall exercise reasonable care, skill and diligence with

(a) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and

(b) any additional knowledge, skill and experience which the director in fact has.”

[47] *Intrico Pte Ltd v Multi-Pak Singapore Ltd* [1995] 1 SLR 313, CA.
[48] Section 132(1A) of CA 1965.
[49] *Chew v R (1991) 5 ACSR 473.*
[50] *Henrick International Hotels & Resorts Pte Ltd v YTL Hotels & Properties Sdn Bhd & Ors & Another Case [2005] 8 CLJ 176.*
[52] *Intraco Ltd v Multi-Pak Singapore Pte Ltd* [1995] 1 SLR 313 at 325, CA.
[52] *Howard Smith Ltd v Ampol Petroleum* [1974] AC 821, PC.

2.12.2 A director is thus required to take, in the performance of his duties, such care as an ordinary man might be expected to take and he is also required to exhibit in the performance of these duties such degree of skill as may reasonably be required from a person with his knowledge and experience.[53]

2.12.3 The recent amendment to section 132 of CA 1965 introduced a new sub-section (1B) whereby a director who makes a business judgment is deemed to meet the requirements of reasonable care, skill and diligence test in sub-section (1A) and the equivalent duties under the common law and equity if the director:

(a) makes the business judgment in good faith for a proper purpose;

(b) does not have a material personal interest in the subject matter of the business judgment;

(c) is informed about the subject matter of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and

(d) reasonably believes that the business judgment is in the best interest of the company.

2.12.4 The 'business judgment rule' describes an American company law rule which prevents the court from questioning the merits of a business judgment made by directors after reasonable investigation, in good faith without personal interest and in reasonable belief that they are acting for the benefit of the company. This rule was developed to protect an honest director and other officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and because of a desire to refrain from stifling innovation and entrepreneurship.

2.12.5 This rule is developed on the general principle that it is not the function of the court to substitute its judgment for the business judgment of a director as it is expected or presumed that a director knows best about the business of the company and have more time and expertise at his disposal to evaluate the best interest of the company. In order to satisfy the business judgment rule, it is not necessary to show that the decision itself was reasonable or that the court would have arrived at the same decision. Rather, it is sufficient for a director to show that he took reasonable steps to inform himself about the subject matter before making the business judgment and that he reasonably believed that judgment was in the best interest of the company.

2.12.6 Whilst this rule has remained as a judicial doctrine in America, Australia has enacted a statutory formulation of this business judgment rule. Section 132(1B) of CA 1965 corresponds with the provisions of the Australian Act.[54]

2.12.7 The business judgment rule only qualifies the scope of the duty to act with reasonable care, skill and diligence prescribed in section 132(1A) of CA 1965. It does not provide a defence to a breach of a director's statutory duty to act for a proper purpose and in good faith in the best interest of the company under section 132(1).

2.13 Duty to avoid conflict of interests and to avoid secret profits

2.13.1 A director has an obligation to avoid conflict of interests. Section 132(2) of CA 1965 codified the common law prohibition against the improper use of the company's property, position and corporate opportunity. This sub-section prohibits a director of a company from using property of the company or his position as a director of the company to gain directly, or indirectly, a benefit for himself or any person, or cause detriment to the company.

2.13.2 A director is regarded as a trustee of the property of the company. Such property may only be used for the purposes of the company. A director who uses the property of the company to make a profit for himself or any other person not only commits a breach of his duty to the company, but will also commit a criminal offence if the property is misappropriated.

2.13.3 The same section also prohibits a director from using any information or opportunity of the company which he acquired or became aware of, in the performance of his functions as a director of the company to gain directly, or indirectly, a benefit for himself or any other person, or cause detriment to the company.

2.13.4 A director who obtains information and knowledge, and which he withholds from the company and uses for his personal gain, will be liable to account for the profits earned. This is because the information had come into his possession when he was a director of the company and the information was relevant for the company to know. The director is not absolved from liability even if the company is not deprived of any profits.[55]

2.13.5 The duty of a director not to make use of his position to obtain a profit for himself is similar to an agent's duty not to make secret profits out of his position as agent. The rule that prohibits a director from making secret profits is so strict that a director is liable to account for profits made in breach of this duty even though the director is not guilty of any moral wrong. Lack of bad faith will not absolve a director from such liability. Once it is established that what the director did was so related to the affairs of the company that it can properly be said to have been done in the course of his management and using his opportunities and special knowledge as directors, the director will be liable to account for the profits obtained.[56]

2.13.6 A director's duty not to usurp for himself, or divert to his associates, a maturing business opportunity which the company is actively pursuing is imposed on the director even after his resignation where the resignation may fairly be said to be prompted or influenced by a wish to acquire for himself the opportunity sought by the company.[57] Therefore, a director's duty does not end upon resignation.

2.13.7 A director is not prohibited from engaging in business which is in competition with the company so long as he does not breach his fiduciary duties and duties of confidentiality to the company. A director is at liberty to be a director of a rival company unless prohibited from doing so by the articles of association of a company.[58]

[53] *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 at 501-502, Foster J.
[54] Section 180 of Corporations Act 2001.
[55] *Industrial Development Consultants v Cooley* [1972] 1 WLR 433.
[56] *Regal (Hastings) Ltd v Gulliver* [1942] All ER 378, HL.
[57] *Canadian Aero Services v O'Malley* [1973] 40 DLR 371, SC.
[58] *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165 cited with approval by *Bell v Lever Bros Ltd* [1932] AC 161, HL and appears to be accepted in *Berli Hestia (NZ) Ltd v Fernybough* [1980] 2 NZLR 151 as the correct legal position in New Zealand.

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 Malaysian 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. Malaysian courts have adopted the English position citing with approval the English authorities.[59] Malaysian law recognises that a company's affairs during this time are not only influenced by those formally appointed as directors but also by a wide range of other people. If such persons have caused loss to the company and its creditors during this time, they may also be found personally liable for such loss. Malaysian law may impose personal liability on "shadow" and "*de facto*" directors in certain circumstances.

3.1.2 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 period" may also have transactions challenged and set aside under the clawback provisions for undue provisions.

3.1.3 Finally, third parties who have knowledge of breach of duty of a director or directors when entering into transactions, or had either fraudulently assisted in that breach and/or received property from the company with knowledge of that breach, will under general equitable principles 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 The concept of "shadow directors" is reflected in CA 1965 to catch persons who, although not on the board or making day to day decisions at the company, are in fact pulling the strings behind the scenes.

3.2.2 Section 4(1) of CA 1965 provides that unless a contrary intention appears, the term 'director':

"includes any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act and an alternate or substitute director."

3.2.3 A director is not necessarily defined by his designation as such but rather by the dominant or controlling role that he plays in the running of the company. Section 4(1) of CA 1965 encompasses a *de facto* as well as a shadow director who is "a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act".[60]

3.2.4 Whilst the terms *de facto* and shadow director have been used interchangeably, case laws have made a distinction between the two terms. There are contrarian authorities in this regard where one school of thought claims that the two terms are mutually exclusive[61] whilst recent judicial dicta held that the two terms are not mutually exclusive and it is possible that a person can conduct himself in a mixture of both.[62] However, a recent Malaysian court has opined that whether the two terms are mutually exclusive or overlap would depend on the particular facts and circumstances of each individual case.[63]

3.3 *De facto* directors

3.3.1 A *de facto* director is a person who, though not validly appointed as such, purports or claims or holds himself out to be a director. To establish that a person was a *de facto* director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly only be discharged by a director. It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.[64]

[59] The English authorities were cited with approval and discussed at great lengths most recently in the case of *Kejutaan Holdings Sdn Bhdv Magnum 4D (Perak) Sdn Bhd & 9 Ors* [2008] 4 AMR 26.

[60] *Cepatwawasan Group Bhd & Anor v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

[61] *Re Hydrodam (Corby) Ltd [1994] 2 BCLC 180; Secretary of State for Trade and Industry v Laing & Ors* [1996] 2 BCLC 324. In Secretary of State for Trade and Industry v Hollier and others [2006] EWHC 1804 (Ch), Mr Justice Etherton commented that *de facto* directorships and shadow directorships are alternatives, although there may be cases, particularly where the defendant's influence in the corporate governance was partly concealed and partly open, where it may not be entirely straightforward which of the two descriptions is most apposite.

[62] *Re Kaytech International plc [1999] BCC 390. In Re Mea Corporation Ltd; Secretary of State for Trade and Industry v Aviss and others* [2006] EWHC 1846 (Ch), Lewinson J agreed with Morritt LJ's explanation regarding the role of a shadow director in *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340, [2000] 2 All ER 365, [2000] 2 WLR 907, and further concluded that that a person can be both a shadow director and a *de facto* director simultaneously. He may, for example, assume the functions of a director as regards one part of the company's activities (say, marketing) and give directions to the board as regards another (say, manufacturing and finance). In each case, it is necessary to examine the facts, bearing in mind that, as Morritt LJ explained, the purpose of the legislation is to *"identify those, other than professional advisers, with real influence in the corporate affairs of the company"*.

[63] *Cepatwawasan Group Bhd & Anor v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

[64] *Re Hydrodam (Corby) Ltd* [1994] BCLC 180.

3.3.2 The question of whether a person is occupying the position of director or not is a question of fact.

3.3.3 A *de facto* director is subject to the same statutory and fiduciary duties as a director who has been validly appointed.[65] A *de facto* director would be liable for any act of commissions or any omission on his part in the same manner and to the same extent as if he had been a *de jure* as well as *de facto* director. It must be shown that something he did resulted in a loss to the company and for which, if he had been duly appointed a director of the company, the company would have been entitled to a remedy against him.

3.3.4 A *de facto* director is also able to bind the company in contracts and agreements with bona fide third parties in his capacity as an agent of the company with actual and/or apparent authority. Under principles of general agency law, he is not personally liable under those contracts but may be liable in damages for breach of an implied warranty of authority if he can be deemed to have warranted that he had authority to act on behalf of the company when no such authority existed.

3.4 Shadow director

3.4.1 A shadow director may not necessarily in all cases act as a director but conceals or hides his role as such.[66] A shadow director has been described to be in reality a puppeteer who pulls the string and his puppets on the board dance.[67] A shadow director is a person who, through directions and instructions to the directors of the company, exercises real influence over some, if not all, of the affairs of the company. He often lurks in the shadows, but it is not a necessary ingredient that he must lurk in the shadows all the time. The primary consideration is whether real influence was exercised and not the means by which influence was exercised.[68]

3.4.2 In order to establish that a person is a shadow director of the company it is necessary to allege and prove:

(i) the identities of the directors of the company, whether *de facto* or *de jure*;

(ii) that the person concerned directed those directors how to act in relation to the company or that he was one of the persons who did so;

(iii) that those directors acted in accordance with such directions; and

(iv) that those directors were accustomed so to act.

3.4.3 In Malaysia, the Report of the Finance Committee on Corporate Governance (February 1999) recognised the difficulty in establishing whether a particular director is acting under the control of another and recommended that considerations be given to deeming significant shareholders of a certain shareholding threshold and above as directors.

'Directions' and 'instructions'

3.4.4 'Directions' and 'instructions' refer to communication between an alleged shadow director and the board of directors. Communication may be written or oral and formal or informal. Whether any particular communication constitutes 'direction' or 'instruction' is a question of fact which is to be objectively ascertained in the light of all evidence.

3.4.5 Whilst it is not necessary to show the existence of actual directions or instructions in order to constitute shadow directorship, there must be evidence of a controlling or commanding role exercised by the 'shadow director' over the *de jure* directors.[69] The implications are that the *de jure* directors did not exercise any discretion or independent judgment but exhibited a pattern of acting in compliance with the directions of the shadow director.[70]

3.4.6 There is no requirement that the *de jure* directors be shown to have acted in a subservient role to the *de facto* or shadow director and the Report referred to above cautioned against going beyond what is required by statute. What is required under section 4(1) of CA 1965 is the lower threshold of compliance rather than subservience to the directions and instructions of the alleged shadow director.

Accustomed to act

3.4.7 The focus of 'accustomed to act' is directed at results flowing from directions and instructions and not the underlying means through which the results are obtained.

3.4.8 The 'influence' also need not be such as to show that the *de jure* director exercises no discretion of his own. He must be the 'cat's paw' of the shadow director. He must act on the directions or instructions of the shadow director as a matter of regular practice.[71] All that is required to constitute 'accustomed to act' is that over a period of time and as a regular course of conduct the communications of the alleged shadow director have been acted upon by proof of results, as opposed to proof of an underlying expectation or understanding that the communication would be acted upon by the recipient.[72]

3.4.9 To construe a person as a shadow director, there must be shown the existence of a 'pattern' of 'custom' in which the shadow director plays a controlling role over the *de jure* director in respect of the management of the company.[73]

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65 *Corporate Affairs Commission v Drysdale* [1978] 141 CLR 236.

66 *Cepatwawasan Group Bhd & Anor v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

67 Walter Woon in Company Law Book, 2nd edn at p. 222.

68 *Re Kaytech International plc* [1999] 2 BCLC 351, CA.

69 *Australian Securities Commission v AS Nominees* [1995] 13 ACLC 1822 relied upon by *Cepatwawasan Group Bhd & Anor v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

70 *Cepatwawasan Group Bhd & Anor v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

71 *Re Unisoft Group Ltd (No.2) Ltd* [1944] BCC 766.

72 *Secretary of State for Trade and Industry v Deverell & Anor* [2000] 2 WLR 907.

73 *Cepatwawasan Group Bhd & Anor v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620. In *Secretary of State for Trade and Industry v Becker* [2002] EWHC 2200 (Ch), Sir Donald Rattee held that proof of a pattern of conduct, in which the *de jure* director is accustomed to act on the instructions or directions of the alleged shadow director, is required. The test is not satisfied by showing that a *de jure* director may have acted, or indeed did act, on such instructions or directions in relation to one event at the end of the company's life.

3.4.10 Section 4(2) of CA 1965 provides that a person who merely gives advice to the directors in his or her professional capacity is not to be regarded as a 'director' for the purposes of section 4(1). This suggests that a professional adviser can be a shadow director if what he is providing the directors is something more than just professional advice.

3.5 Officers

3.5.1 Liability for many of the acts identified in question 2 above is often imposed on an 'officer' of the company. Section 4(1) of CA 1965 defines 'officer' to include directors, secretaries, employees and receivers and managers, and liquidators under a voluntary winding up.

3.6 Other third parties who may be held liable

3.6.1 A third party may be held liable either to return such property or provide such compensation as the court may order if he receives property as a result of transactions at undervalue, preference or as a result of a transaction defrauding creditors.

3.6.2 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 validation, the disposal will be void.[74]

3.6.3 A third party who is knowingly a party to the carrying on of a business with the intent to defraud creditors will be liable for fraudulent trading.

3.6.4 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 a breach will be liable for any loss arising.

3.7 Summary

3.7.1 Liability may attach to persons not formally appointed as directors for the following offences:

Offence/Activity	**Persons liable**	**Extent of liability**
Insolvent trading	Officer of a company	Same as for director
Fraudulent trading	Any person who was knowingly a party to the carrying on of the business for a fraudulent purpose	Same as for director
Misconduct in the course of a company being wound up	Past or present officer or a contributory of the company	Same as for director
Fraud in the course of a company being wound up	Past or present officer or a contributory of the company	Same as for director
Falsification of books	Every officer or contributory of a company	Same as for director
Proper accounts not kept	Officer of a company	Same as for director
False representations to creditors	Past or present officer or a contributory of the company	Same as for director
Material omissions from statement relating to company's affairs	Past or present officer or a contributory of the company	Same as for director
Misfeasance or breach of trust or duty	Any person who has taken part in the formation or promotion of the company or any past or present liquidator or officer who has misapplied or retained or become liable or accountable for any money or property of the company or been guilty of any misfeasance or breach of trust or duty in relation to the company	Same as for director
Preference	Recipient of preference. Return of property received or removal of specific benefit received.	Same as for director
Sale at undervalue or overvalue	Recipient of property received	Return of property received and/or pay compensation to the company

[74] Section 223 of CA 1965.

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 As in most legal systems, Malaysian law too has provisions that 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

4.2.1 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) sale at an undervalue or overvalue;

(b) undue preference;

(c) invalid floating charges;

(d) breach of a director's fiduciary duties;

(e) disclaimer of onerous property;

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

(g) failure to register a charge.

4.3 Sale at undervalue or acquisition at an overvalue[75]

4.3.1 Section 295 of CA 1965 provides as follows:

(1) Where any property, business or undertaking has been acquired by a company for a cash consideration within a period of two years before the commencement of the winding up of the company:

(a) from a person who was at the time of the acquisition a director of the company; or

(b) from a company of which, at the time of the acquisition, a person was a director who was also a director of the first-mentioned company, the liquidator may recover from the person or company from which the property, business or undertaking was acquired any amount by which the cash consideration for the acquisition exceeded the value of the property, business or undertaking at the time of its acquisition.

4.3.2 Conversely, in similar circumstances, where the company has sold any such property, the liquidator may recover from the person or company to whom the property, business or undertaking was sold, any amount by which the value of the property, business or undertaking at the time of the sale exceeded the cash consideration.[76]

Conditions for setting aside a sale at undervalue or acquisition at an overvalue

4.3.3 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 and an application is made by the liquidator;

(2) the company acquired/sold property, business or undertaking within a period of two years before the commencement of the winding up of the company; and

(3) the property, business or undertaking was acquired/sold for a cash consideration. 'Cash consideration' means a consideration for the acquisition or sale which is payable otherwise than by an issue of shares in the company.[77]

4.3.4 'Value' includes the value of any goodwill or profits which might have been made from the business or undertaking or similar considerations.[78]

[75] Section 295 of CA 1965.
[76] Section 295(2) of CA 1965.
[77] Section 295(4) of CA 1965.
[78] Section 295(3) of CA 1965.

4.4 Undue preference[79]

4.4.1 Section 293 of CA 1965 deals with undue preferences. This section incorporates the provisions of section 53 of the Bankruptcy Act 1967 (BA 1967), by giving the liquidator the power to recover the value of certain pre-liquidation dispositions of the company's property from creditors. These dispositions are referred to as preferences. Section 293 is designed to preserve the sanctity of the pari passu principle by which creditors in a winding up share rateably in the assets available for distribution.[80]

4.4.2 By virtue of section 53 of BA 1967, every transfer of property, every payment made and every obligation incurred by any person unable to pay his debts as they become due, from his own money in favour of any creditor shall be deemed to have given a creditor a preference over other creditors if the person making the same is adjudged bankrupt on a petition presented within six months after making the same and such act shall be deemed fraudulent and void as against the Director General of Insolvency.

4.4.3 There is no requirement in section 53(1) of BA 1967 that the transactions were carried out with the view to creating a preference or with a desire to produce the effect of preference.

4.4.4 The transactions which will be void as being undue preferences are inter alia payments made to an existing creditor within the six month period prior to the presentation of the winding up petition. The commencement date of winding up is deemed to be:

(i) the date of presentation of the winding up petition; or

(ii) where before the presentation of the petition a resolution has been passed by the company for voluntary winding up, the date upon which the resolution to wind up the company voluntarily is passed,

whichever is the earlier; and

(iii) in the case of a voluntary winding up, the date upon which the winding up is deemed by CA 1965 to have commenced.

4.4.5 The effect of the payment on the other creditors is to be determined objectively. The test is whether the payment has the effect of giving a creditor a preference over the other creditors and it is irrelevant whether the debtor intended to give the creditor preferential treatment.[81]

4.4.6 Whilst section 53(1) of BA 1967 declares the preferences are void, it is settled law that 'preferences' relating to companies are merely voidable at the option of the liquidator.[82]

Conditions for setting aside a 'preference'

4.4.7 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:

(i) the transaction in question must take place within six months prior to the commencement of the winding up;

(ii) it must be the type of transaction mentioned in section 53(1) of BA 1967;

(iii) it took place at a time when the company was insolvent;

the person in whose favour the transaction was effected was a creditor to the company; and

(v) the effect of that transaction was to confer on that person a preference, priority or advantage over other creditors in the winding up.[83]

4.4.8 Under section 53 of BA 1967, it appears that if the five conditions are proved, preference is deemed to have been given and shall be deemed to be fraudulent and void.

4.5 Invalid floating charges[84]

4.5.1 Section 294 of CA 1965 deals specifically with the situation where the security takes the form of a floating charge. A floating charge on the undertaking or property of the company created within six months of the commencement of the winding up is 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 at five per cent per annum.[85] The floating charge is not invalid if the creditor proves the company was solvent immediately after the creation of the charge.

4.5.2 This section aims to prevent companies which are on the verge of insolvency from securing past debts by granting floating charges over its assets in favour of particular creditors.

Conditions for setting aside

4.5.3 A floating charge on the undertaking or property of the company is invalid under this provision if the following conditions are satisfied:

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79 Section 293 of CA 1965.

80 *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1998] 4 MLJ 569.

81 *Arab Malaysian Merchant Bank Bhd v Orient Apparel Bhd & Ors* [2002] 1 MLJ 89 following the Australian High Court case of *Airservices v Ferrier 21 ACSR 1*.

82 *Meiden Electric Sdn Bhd v Mtrans Holdings Sdn Bhd* [2006] 5 MLJ 749, *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1998] 4 MLJ 569.

83 *Sime Diamond Leasing (Malaysia) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liq)* [1998] 4 MLJ 569, *Bensa Sdn Bhd (in liquidation) v Malayan Banking Bhd & Anor* [1993] 1 MLJ 119. This case was referred to and followed in *Tee Siew Kai v Affin Bank and Anor* [2011] 4 MLJ 491.

84 Section 294 of CA 1965.

85 *See Sabah Bank Bhd v Ho Juan Hua & Anor* [1993] 3 MLJ 113.

(i) the company is insolvent; and

(ii) the charge is created within six months of the commencement of winding up.

4.5.4 It should be noted that section 294 of CA 1965 only invalidates the floating charge and not the debt. The debt can still be proved.[86] Further, the section only affects the recovery of money under the debenture creating a floating charge. It does not affect the ability to recover money secured by a separate contract of guarantee.[87]

4.6 Breach by directors of general/common law duties

4.6.1 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.

4.7 Disclaimer of onerous property[88]

4.7.1 In order to preserve the remaining assets of the company, section 296 of CA 1965 enables the liquidator to disclaim any onerous property on behalf of the company.

4.7.2 This includes:[89]

(a) any estate or interest in land which is burdened with onerous covenants;

(b) shares in corporations;

(c) unprofitable contracts; or

(d) any other property that is unsaleable, or not readily saleable, by reason of it binding the possessor to the performance of any onerous act, or to the payment of any sum of money.

4.7.3 The purpose of the power of disclaimer is to relieve the company of an asset, which in reality is merely a liability. This power may only be exercised within 12 months after the commencement of the winding up and only with the leave of the court or the committee of inspection. The disclaimer operates to terminate the rights, interests and liabilities of the company as from the date of disclaimer.[90] However, all liabilities arising up to the date of commencement of winding up remain and rank with other debts of equal priority.

4.7.4 The disclaimer determines the rights, interest and liabilities of the company and the property 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 injured by the operation of a disclaimer is deemed to be a creditor of the company to the amount of the injury, and may prove the amount as a debt in the winding up.[91]

4.7.5 There can be no disclaimer if the liquidator fails, within a period of twenty-eight days after the receipt of an application requiring him to decide whether he will or will not disclaim, to give notice to the applicant that he intends to apply to court or committee for leave to disclaim.[92]

4.8 Disposition of property of the company made after the commencement of winding up[93]

4.8.1 Section 223 of CA 1965 provides that any disposition of the company's property including things in action and any transfer of shares or alteration in the status of the members of the company made after the commencement of the winding up by the court is void, unless validated by the court.

4.8.2 A company 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 creditors. The question of validating such transaction is at the discretion of the court, following an application by the person seeking an order for validation.[94] The commencement of the winding up backdates to the date of presentation of the petition for compulsory winding-up if an order is ultimately made.

4.9 Failure to register a charge[95]

4.9.1 Section 108 of CA 1965 sets out the charges (whether legal or equitable) which must be registered with the Registrar of Companies. The charges required to be registered under section 108(3) of CA 1965 are:

(a) a charge to secure any issue of debentures;

(b) a charge on uncalled share capital of a company;

(c) a charge on shares of a subsidiary of the company which are owned by the company;

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86 *Re Parkes Garage (Swadlincote) Ltd* [1929] 1 Ch 139.
87 *Sabah Bank Bhd v Ho Juan Hua & Anor* [1993] 3 MLJ 113.
88 Section 296 of CA 1965.
89 Section 296 of CA 1965.
90 Section 296(2) of CA 1965.
91 Section 296(8) of CA 1965.
92 Section 296(4) of CA 1965.
93 Section 223 of CA 1965.
94 *Kimoyana Elektrik (M) Sdn Bhd v Metrobilt Construction Sdn Bhd* [1990] 3 MLJ 309.
95 Section 108 of CA 1965.

(d) a charge or an assignment created or evidenced by an instrument which if executed by an individual within Peninsular Malaysia and affecting property within Peninsular Malaysia would be invalid or of limited effect if not filed or registered under the Bills of Sale Act, 1950;

(e) a charge on land wherever situate or any interest therein;

(f) a charge on book debts of the company;

(g) a floating charge on the undertaking or property of a company;

(h) a charge on calls made but not paid;

(i) a charge on a ship or aircraft or any share in a ship or aircraft;

(j) a charge on goodwill, on a patent or licence under a patent, on a trade mark, or on a copyright or a licence under a copyright; and

(k) a charge on the credit balance of the company in any deposit account.

4.9.2 It appears that the charges required to be registered under section 108(3) of CA 1965 are exhaustive. This is because charges which are not referred to in section 108 of CA 1965 do not require registration; for instance fixed charges over partnership interests and commercial contracts.[96]

4.9.3 Where a company does not lodge a notice of charge within the prescribed period of 30 days after its creation, the charge will be void as against the liquidator or any creditor of the company. The time limit of 30 days is subject to any extension ordered by the court under section 114 of CA 1965. Where the charge is void against a liquidator, the chargee nevertheless remains a creditor of the company, but without security, thereby rendering him or her as merely an unsecured creditor of the company. Section 108 of CA 1965 applies without prejudice to any contract or obligation for repayment of the money secured by a charge. When a charge becomes void under this section, the money secured thereby shall immediately become payable.[97] This means that the contract, or obligation for repayment of the money secured by the charge, would be valid and enforceable, and would immediately become payable.[98]

4.9.4 The main purpose of these provisions is to enable a potential creditor of that company, who proposes to lend money on security of particular assets, to ascertain whether the company has already given a charge over those assets. They also enable an unsecured creditor to determine the extent to which the assets of a company have been charged, and thereby to ascertain the rights of secured creditors who rank ahead of an unsecured creditor in priority of payment.

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 assets of the company for the benefit of the 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. Consequently, in most cases, it is the liquidator who is empowered to bring actions against directors.

5.2 Criminal proceedings

5.2.1 In the course of a winding up of a company by the court, if it appears to the court that any past or present officer, or any member of the company has been guilty of an offence in relation to the company for which he is criminally liable, the court may direct the liquidator either himself to prosecute the offender or to refer the matter to the Minister charged with the responsibility for companies within section 4 of CA 1965 (Minister). The court may give such directions either on the application of a person interested in the winding up or of its own motion.[99]

5.2.2 In the case of a voluntary winding up, where it appears to the liquidator that such persons mentioned above are guilty of such offences, the liquidator must report forthwith the matter to the Minister and furnish the Minister with such information or documents relating to the matter and give to him such access to and facilities for inspecting and taking copies of any documents as may be required.[100]

5.2.3 The Minister may, if he thinks fit, investigate the matter and may then apply to the court for an order conferring on him or any other person designated by him powers of investigating the affairs of the company as are provided by CA 1965 in the case of a winding up by the court.[101] If the Minister considers that the case is one in which a prosecution ought to be instituted, he may institute proceedings accordingly, and the liquidator and all past and present officer and agent of the company shall give the Minister or Official Receiver all assistance in connection with the prosecution which they are reasonably able to give.[102]

96 *United Builders Pty Ltd v Mutual Acceptance Ltd* [1980] 144 CLR 673 (HC).
97 Section 108(2) of CA 1965.
98 *Sime Diamond Leasing (Malaysia) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (in liq.)* [1998] 4 MLJ 569, 584.
98 Section 306(1) of CA 1965.
100 Section 306(2) of CA1965.
101 Section 306(4) of CA 1965.
102 Section 306(6) of CA 1965.

5.2.4 If any person fails or neglects to give assistance in the manner as required, the court may, on an application of the Minister or official receiver, direct that person to provide such assistance. If the application is made with respect to a liquidator, unless it appears that the failure or neglect to comply was due to the liquidator not having in his hands sufficient assets of the company to enable him to do so, the court may direct that the costs of the application be borne by the liquidator personally.[103]

5.2.5 The Minister may direct that the whole or any part of any costs and expenses properly incurred by the liquidator in such proceedings be defrayed out of moneys provided by Parliament.[104] All other costs and expenses shall be payable out of the assets of the company as part of the costs of winding up.[105]

5.2.6 However, if it appears to the Minister that the case is not one in which proceedings ought to be taken by him, he shall inform the liquidator accordingly, and thereupon subject to the approval by the court, the liquidator may himself take proceedings against the offender.[106]

5.2.7 Section 371(1) of CA 1965 provides that except where provision is otherwise made in CA 1965 proceedings, for any offence of that Act may be taken by the Registrar or, with the written consent of the Minister, by any person.[107]

5.2.8 The following are criminal offences in CA 1965 in respect of which either the liquidator or Minister may bring an action against the directors and others involved:

(a) inducement to be appointed liquidator – section 301;

(b) falsification of books - section 302;

(c) proper accounts not kept - section 303(1);

(d) insolvent trading - section 303(3);

(e) fraudulent trading - section 304;

(f) misconduct in the course of company being wound up - section 300(1)(a), (b), (e) and (f);

(g) fraud in the course of company being wound up - section 300(1)(c);

(h) false representations to creditors - section 300(1)(h);

(i) material omissions from statement relating to company's affairs - section 300(1)(d); and

(j) misfeasance or breach of trust or duty - section 305.

5.3 Civil proceedings

5.3.1 As for civil proceedings, the ability to bring actions against directors and others is primarily held by the liquidator of the company.

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.

Activity/transaction	**Person able to bring proceedings**
Misfeasance	Liquidator, creditor or contributory of the company
Fraudulent trading	Liquidator, creditor or contributory of the company
Insolvent trading	Liquidator, creditor or contributory of the company
Sale at undervalue or acquisition at overvalue	Liquidator only
Undue preference	Liquidator, creditor or contributory of the company
Disposition of the company's	Liquidator, creditor or shareholder[108] of the company
Disqualification as director	Registrar, Official Receiver or any person. Any person intending to apply for the leave of court for this order must give to the Registrar notice of his intention to apply and the Registrar shall be made a party to the proceedings.
Breach of director's duties	Liquidator only

103 Section 306(8) of CA 1965.
104 Section 306(9) of CA 1965.
105 Section 306(10) of CA 1965.
106 Section 306(4) of CA 1965.
107 This is in contrast to Article 145(3) of the Federal Constitution which provides that the powers to institute, conduct or discontinue any proceedings for a criminal offence are vested in the Attorney-General. Pursuant to section 376(i) of the Criminal Procedure Code, the Attorney-General shall be the Public Prosecutor and shall have the control and direction of all criminal prosecutions and proceedings under the said Code.
108 *Re Argentum Reductions (UK) Ltd* [1975] 1 All ER 605.

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
Falsification of books	The penalty is imprisonment for five years or a RM30,000.00 fine.
Inducement to be appointed liquidator	The penalty is imprisonment for one year or a RM1,000.00 fine.
Proper accounts not kept	The penalty is imprisonment for three years or a RM10,000.00 fine.
Insolvent trading	The court may, on the application of the liquidator or any creditor or contributory of the company, declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt. The court also has powers to make consequential orders to give effect to the declaration above. Where the court makes a declaration under section 303(3) of CA 1965 that an individual is liable to make contribution to the company's assets, then whether or not an application has been made for his disqualification, the court may make an order that the individual be disqualified from acting as a company director and prohibit him from being in any way concerned in or taking part in the management of a corporation for a period of five years from the date of order.
Insolvent trading	The penalty is imprisonment for one year or a RM5,000.00 fine.
Fraudulent trading	The court may, on the application of the liquidator or any creditor or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in that manner shall be personally responsible without any limitation of liability, for all or any of the debts or other liabilities of the company. The court also has powers to make consequential orders to give effect to the declaration above. Where the court makes a declaration under section 304 of CA 1965 that an individual is liable to make contribution to the company's assets, then whether or not an application has been made for his disqualification, the court may make an order that the individual be disqualified from acting as a company director and prohibit him from being in any way concerned in or taking part in the management of a corporation for a period of five years from the date of order.
Fraudulent trading	The penalty is imprisonment for three years or a RM10,000.00 fine.
Misconduct in the course of company being wound up	The penalty is imprisonment for two years or a RM5,000.00 fine.
Fraud in the course of company being wound up	The penalty is imprisonment for two years or a RM5,000.00 fine.
False representations to creditors	The penalty is imprisonment for two years or a RM5,000.00 fine.
Material omissions from statement relating to company's affairs	The penalty is imprisonment for two years or a RM5,000.00 fine.
Misfeasance	The court may order the 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 misapplication, retainer, misfeasance or breach of trust or duty as the court thinks just.
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 or profits 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 duty of skill and care.
Conduct rendering a director to be concerned in the management of a company	The court may order disqualification for a period not exceeding five years. There is no unfit financial penalty.[109]
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.
Invalid floating charges	The court can declare that the floating charge is invalid.

[109] Section 130A of CA 1965.

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

7.1.1 There is no provision in CA 1965 imposing a general duty on directors and others involved in the affairs of the company to co-operate with a liquidator, provisional liquidator or Official Receiver, as can be found under English law in section 235 Insolvency Act 1986 (IA 1986). Liquidators in Malaysia must rely on the specific provisions which are set out below when investigating the company's affairs.

7.1.2 A person is guilty of an offence against CA 1965 if he:[110]

(a) does an act which by or under CA 1965 he is forbidden to do;

(b) does not do that which by or under CA 1965 he is required or directed to do; or

(c) otherwise contravenes or fails to comply with any provision of CA 1965.

7.1.3 A person who is convicted of an offence under CA 1965 shall be liable to a penalty or punishment not exceeding that expressly mentioned for the offence, or if no such penalty or punishment is expressly mentioned, to a penalty not exceeding RM5,000.00.[111]

7.2 Obligation to produce for inspection books and papers of the company[112]

7.2.1 The court may order the inspection of the books and papers of the company by creditors and contributories as the court thinks just, and any books and papers in the possession of the company may be inspected by creditors or contributories accordingly.[113]

7.3 Company's statement of affairs[114]

7.3.1 In a compulsory liquidation, section 234 of CA 1965 requires persons who were the directors and secretary at the time of the winding up order to submit a report to the liquidator in the prescribed form as to the affairs of the company. This statement as to the affairs of the company as at the date of the winding up order must show:

(i) the particulars of its assets, debts and liabilities;

(ii) the names and addresses of its creditors;

(iii) the securities held by them respectively;

(iv) the dates when the securities were respectively given; and

(v) such further information as is prescribed or as the Official Receiver or the liquidator requires.

7.3.2 The report must be submitted within 14 days after the making of the winding up order unless otherwise extended.[115] Persons who may also be required to supply information on the affairs of the company if requested by the liquidator are:

(i) present or former officers;

(ii) persons who have taken part in the formation of the company within a year of the date of the winding up order; or

(iii) persons who are or have been within that period officers in the employment of a corporation which is, or within that period was, an officer of the company to which the statement relates.[116]

7.3.3 Such persons making the statement may be paid, out of the assets of the company, such costs and expenses incurred in and about the preparation and making of the statement as the Official Receiver or the liquidator considers reasonable.[117]

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[110] Section 369(1) of CA 1965. In *Lembaga Kumpulan Wang Simpanan Pekerja v Adorna RMIT Sdn Bhd & Ors* [2003] 4 MLJ 729, the court held that the relevant section is sufficient to include the director's liability which was joint and several. Kamalanathan Ratnam J added that as directors are the alter ego of a company, it is therefore not appropriate for a director to attempt to escape culpability by pleading that he is a sleeping partner or director, or a silent director or a non-active director.

[111] Section 369(2) of CA 1965.

[112] Section 248 of CA 1965.

[113] In *SP Setia Berhad v Gasing Heights Sdn Bhd* [2004] MLJU 498, Abdul Wahab JC found that a creditor may apply for inspection of the books and papers of the company which are with the liquidator. The right of a petitioner in respect of those documents relating to certain questionable transaction would be entertained by the court if the liquidator had not requested the directors to do so or having done so, the directors had failed to surrender them.

[114] Section 234 of CA 1965.

[115] Section 234(3) of CA 1965.

[116] Section 234(2) of CA 1965.

[117] Section 234(4) of CA 1965.

7.3.4 Every person who commits a default in submitting such a report without reasonable excuse shall be liable to imprisonment for three years or a fine of RM10,000.00 or both.[118] The liquidator shall report such default to the court.[119]

Preparation of statement of affairs[120]

7.3.5 The liquidator may from time to time hold personal interviews with such persons who are required to submit and verify a statement of affairs of the company mentioned above for the purpose of investigating the company's affairs. Such persons are duty bound to attend on the liquidator at such time and place as the liquidator may appoint and give the liquidator all information that he may require.[121]

Information subsequent to statement of affairs

7.3.6 After the statement of affairs of a company has been submitted to the liquidator, it shall be the duty of each person who has made or concurred in making it, if and when required, to attend on the liquidator and answer all such questions as may be put to him and give all such further information as may be required of him by the liquidator in relation to the statement of affairs.

7.4 Private examination[122]

7.4.1 The court may summon before it and examine on oath any officer of the company or person:

(i) who is known or suspected to have in his possession any property of the company; or

(ii) who is supposed to be indebted to the company; or

(iii) whom the court deems capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company.[123]

7.4.2 The court may examine such persons on oath either by word of mouth or on written interrogatories and may reduce his answers to writing and require him to sign them, and any writing so signed may be used in evidence in any legal proceedings against him.[124]

7.4.3 Such persons may also be required to produce any books and papers in his custody or power relating to the company. However, where he claims any lien on books or papers the production shall be without prejudice to that lien, and that the court shall have jurisdiction to determine all questions relating to that lien.[125]

7.4.4 If any person so summoned after being tendered a reasonable sum for his expenses refuses to come before the court at the time appointed not having a lawful excuse, the court may cause him to be apprehended and brought before the court for examination.[126]

7.4.5 The proposed examinee can oppose or discharge an application for examination by showing:

(a) a case of oppression or unfair prejudice;

(b) that the information is not reasonably required;

(c) the liquidator is acting inappropriately outside his statutory functions or is motivated by improper considerations;

(d) that there has been a lack of full and frank disclosure by the liquidator; or

(e) that the examination is sought to give the company an undue tactical advantage.[127]

7.5 Public examination of officers[128]

7.5.1 The liquidator is obliged to submit a preliminary report to the court as soon as practicable after receipt of the statement of affairs from one of the persons identified in section 234(2) of CA 1965.[129] In his report, he may opine as to whether any fraud has been committed or any material fact has been concealed by any person in the promotion or formation of the company or by an officer in relation to the company since its formation or that an officer has failed to act honestly and diligently or has been guilty of any impropriety or recklessness in relation to the affairs of the company.[130]

7.5.2 Where the liquidator has submitted a report under section 235(2) of CA 1965 the court may, after consideration of the report publicly examine:

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118 Section 234(5) of CA 1965.
119 Rule 44 of Companies (Winding Up) Rules 1972.
120 Rule 41 of Companies (Winding Up) Rules 1972.
121 Rule 41(2) of Companies (Winding Up) Rules 1972.
122 Section 249 of CA 1965.
123 Sections 249(1) and (2) of CA 1965.
124 Section 249(2) of CA 1965. In *Cloverbay Ltd v BCCI Ltd* [1991] 1 All ER 894, the English Court of Appeal held that in exercising the discretion to order examination of a party, the court has to balance the requirements of the applicant against any possible oppression to the person to be examined. If the information required is so fundamental to any assessment of whether there is a cause of action against that party and the degree of oppression is small, the order should be made. The case for ordering against an officer or former officer of the wound up company is stronger than it would be against a third party as officers owe fiduciary duties to the company.
125 Section 249(3) of CA 1965.
126 Section 249(5) of CA 1965.
127 *Hicom Bhd v Bukit Cahaya Country Resorts Sdn Bhd* [2005] MLJU 418. In *Liquidators of W&P Piling Pte Ltd v Chew Yin What* [2004] 3 SLR 164, the Singaporean High Court held that an examination under section 249 must not be used for improper third party collateral purposes that afforded no benefit to the winding up of the company.
128 Section 250 of CA 1965.
129 Section 235(1) of CA 1965.
130 Section 235(2) of CA 1965.

(i) any person or officer; or

(ii) any other person who was previously an officer of the company, including any banker, advocate or auditor; or

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

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

7.5.3 The court may direct that such person shall attend before the court on a day appointed and be publicly examined as to the promotion or formation or the conduct of the business of the company, or in the case of an officer or former officer as to his conduct and dealings as an officer thereof.[131]

7.5.4 In the examination, the court may put or allow to be put such questions as the court thinks fit.[132]

7.5.5 The person is examined under oath and is obliged to answer all such questions as the court puts or allows to be put.[133] The notes of the examination:[134]

(i) shall be reduced into writing;

(ii) shall be read over to or by and signed by the person examined;

(iii) may thereafter be used in evidence in any legal proceedings against him; and

(iv) shall be open to the inspection of any creditor or contributory at all reasonable times.

7.6 Obligation to assist with delivery of property to liquidator[135]

7.6.1 A liquidator may apply to the court for orders requiring certain persons to hand over any money, property, books and papers to which the company is prima facie entitled. Such persons include any contributory, trustee, receiver, banker, agent or officer of the company. The court may require such persons forthwith or within such time as the court directs to pay, deliver, convey, surrender or transfer such property to the liquidator or provisional liquidator.[136]

7.7 Sanction for absconding contributories[137]

7.7.1 The court may cause a contributory, director or former director of the company to be arrested and his books and papers and movable personal property to be seized from him, to be safely kept until such time as the court orders, on proof of probable cause for believing that such person:

(i) is in hiding or had absconded; or

(ii) is about to quit Malaysia or otherwise to abscond or to remove or conceal any of his property for the purpose of evading payment of calls or of avoiding examination respecting the affairs of the company; or

(iii) is otherwise avoiding, delaying or embarrassing proceedings in the winding up.

7.7.2 The court may make such order at any time before or after making a winding up order.

7.8 Human rights

7.8.1 The Human Rights Commission of Malaysia Act 1999 (HRCMA 1999) came into force on 20 April 2000 which essentially gave statutory recognition to the Universal Declaration of Human Rights 1948 (1948 Declaration). In furtherance of the protection and promotion of human rights in Malaysia, the functions of the Commission shall be:

(a) to promote awareness of and provide education in relation to human rights;

(b) to advise and assist the Malaysian Government in formulating legislation and administrative directives and procedures and recommend the necessary measures to be taken;

(c) to recommend to the Malaysian Government with regard to the subscription or accession of treaties and other international instruments in the field of human rights; and

(d) to inquire into complaints regarding infringements of human rights referred to in section 12 HRCMA 1999.

7.8.2 Section 4(4) HRCMA 1999 provides that for the purpose of the Act, regard shall be had by the courts[138] to the 1948 Declaration to the extent that it is not inconsistent with the Federal Constitution.

[131] Section 250(1) of CA 1965.
[132] Section 250(3) of CA 1965.
[133] Section 250(4) of CA 1965.
[134] Section 250(7) of CA 1965.
[135] Section 277(5) of CA 1965.
[136] The section does not apply where there is a bona fide dispute as the company is not then 'prima facie entitled'; Re Palace Restaurants [1914] 1 Ch 492.
[137] Section 251 of CA 1965.
[138] *Mohamad Ezam Mohd Noor v Ketua Polis Negara & Other Appeals* [2002] 4 CLJ 309 (FC) where Siti Norma Yaakob FCJ stated that *"the use of the words 'regard shall be had' in s. 4(4) of the Human Rights Commission of Malaysia Act can only mean an invitation to look at the 1948 Declaration if one was disposed to do and to consider the principles stated therein and be persuaded by them if need be."*

7.8.3 However, the Malaysian Federal Court has opined that the 1948 Declaration is not legally binding on Malaysian courts.[139]

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 Section 371(2) of CA 1965 provides that:

Notwithstanding anything in CA 1965 proceedings for any offence against the Act may be brought within the period of seven years after the commission of the alleged offence or, with the consent of the Minister, at any later time.

Limitation Period for Civil Actions

8.1.2 In relation to any liabilities created by the provisions of CA 1965, the limitation period is six years from the date on which the cause of action accrued.[140]

8.1.3 In relation to breaches of the director's fiduciary duties, the limitation period is generally six years from the date on which the cause of action accrued.[141]

8.1.4 In relation to breaches of the director's common law duties, the limitation period is also six years from the date on which the cause of action accrued.[142]

8.2 Appeals

Winding up

8.2.1 The High Court[143] or a judge thereof has jurisdiction over winding up proceedings.[144]

8.2.2 Winding up orders can be withdrawn, altered or modified before being perfected.[145] Once perfected, the order cannot be discharged or varied; any application to discharge or vary the order must be by way of appeal. The decision of the High Court is appealable. There are two levels of appeals, namely to the Court of Appeal, and thereafter to the Federal Court (with leave).

8.2.3 The appeal to the Court of Appeal in relation to a petition for winding up is as of right, and no leave of court is required. The Court of Appeal may review the exercise of the High Court's discretion in making the order to wind up the company. However, the Court of Appeal would not interfere with the exercise of the discretion unless:

(i) it was exercised on a wrong principle;

(ii) it was obviously "misused"; or

(iii) it has effected a substantial injustice to one or other of the parties.[146]

8.2.4 The final level of appeal is to the Federal Court, and leave must be obtained from the Federal Court before the appeal can be made. Section 96 of the Courts of Judicature Act 1964 provides that:

139 *Mohamad Ezam Mohd Noor v Ketua Polis Negara & Other Appeals* [2002] 4 CLJ 309 (FC). The Federal Court upheld the case of *Merdeka University Berhad v. Government of Malaysia* [1981] 1 CLJ 175; [1981] CLJ (Rep) 191 where the 1948 Declaration was described as a non-legally binding instrument as some of its provisions depart from existing and generally accepted rules; "It is merely a statement of principles devoid of any obligatory character and is not part of our municipal law". *"It must be borne in mind that the 1948 Declaration is a resolution of the General Assembly of the United Nations and not a convention subject to the usual ratification and accession requirements for treaties. By its very title it is an instrument which declares or sets out statement of principles of conduct with a view to promoting universal respect for and observance of human rights and fundamental freedoms. Since such principles are only declaratory in nature, they do not, I consider, have the force of law or binding on Member States. If the United Nations wanted those principles to be more than declaratory, they could have embodied them in a convention or a treaty to which Member States can ratify or accede to and those principles will then have the force of law. The fact that regard shall be had to the 1948 Declaration as provided for under s. 4(4) of the Human Rights Commission of Malaysia Act 1999 makes no difference to my finding. This is so as my understanding of the pertinent words in the sub-section that 'regard shall be had' can only mean an invitation to look at the 1948 Declaration if one is disposed to do so, consider the principles stated therein and be persuaded by them if need be. Beyond that one is not obliged or compelled to adhere to them. This is further emphasised by the qualifying provisions of the sub-section which states that regard to the 1948 Declaration is subject to the extent that it is not inconsistent with our Federal Constitution."*

140 Section 6(1)(d) of the Limitation Act, 1953.

141 Section 22(3) of the Limitation Act, 1953.

142 Section 6(1)(a) of the Limitation Act, 1953 in the case of liability founded in tort.

143 *Goh Boon Kim v Taman Sungai Dua Development Sdn Bhd* [1995] 4 MLJ 553, it was held that the plaintiff is entitled to file an action in any branch of the high court in Malaya irrespective of where the respondents are situated.

144 Section 4 of CA 1965.

145 *Apirami Sdn Bhd v Tamil Nesan (M) Sdn Bhd* [1986] 1 CLJ 493.

146 *Malayan Plant (Pte) Ltd v Moscow Narodny Bank Ltd* [1980] 2 MLJ 53.

Subject to any rules regulating the proceedings of the Federal Court in respect of appeals from the Court of Appeal, an appeal shall lie from the Court of Appeal to the Federal Court with the leave of the Federal Court:

(a) from any judgment or order of the Court of Appeal in respect of any civil cause or matter decided by the High Court in the exercise of its original jurisdiction involving a question of general principle decided for the first time or a question of importance upon which further argument and a decision of the Federal Court would be to public advantage; or

(b) from any decision as to the effect of any provision of the Constitution including the validity of any written law relating to any such provision.

Civil suit

8.2.5 Hearings take place at first instance either at a Magistrates Court, Sessions Court or the High Court depending on the nature of the case and the value of the amount in issue. The Magistrates Court[147] has jurisdiction to try all actions and suits of a civil nature where the amount in dispute or the value of the subject matter does not exceed RM25,000.00 whereas the Sessions Court[148] has jurisdiction where the amount in dispute or the value of the subject matter does not exceed RM250,000.00 save for actions and suits in respect of motor vehicle accidents, landlord and tenant and distress, where the Sessions Court has unlimited jurisdiction. The High Court shall have jurisdiction where the value of the amount in issue exceeds RM250,000.00.

8.2.6 The Subordinate Courts Act 1948 was recently amended by virtue of the Subordinate Courts (Amendment) Act 2010 which has been passed and received Royal Assent on 8 September 2010. This Amendment Act has not come into force yet. The amendments would increase the monetary jurisdiction of the Magistrate Court to try all actions and suits of a civil nature where the amount in dispute or value of the subject matter does not exceed RM100,000.00. The monetary jurisdiction of the Sessions Court would also be increased to try all other actions and suits of a civil nature where the amount in dispute or the value of the subject matter does not exceed RM1,000,000.00.[149]

8.2.7 In addition, section 69 of the Subordinate Courts Act 1948 sets out the subject matters where an action must commence at the High Court.

8.2.8 If the court of first instance is the Magistrates Court/Sessions Court (subordinate courts), the aggrieved party may appeal to the High Court and thereafter the Court of Appeal. There can be no appeal to the High Court from a decision of a subordinate court where the amount in dispute or the value of the subject matter is RM10,000.00 or less except on a question of law.[150] The final level of appeal here is the Court of Appeal. Section 67(1) of the Courts of Judicature Act 1964 states that the Court of Appeal has jurisdiction to hear and determine appeals from any judgment or order of any High Court subject to the Act or any other written law.

8.2.9 Where the amount of claim exceeds RM250,000.00, the appeal to the Court of Appeal is as of right. There is a right to appeal without leave of court[151] for, inter alia a certiorari, declaration, injunction, and petition for winding up bankruptcy proceedings. Leave of court is required where the amount of claim is less than RM250,000.00 or the judgment is on costs only. However, there can be no appeal where by any written law for the time being in force, the judgment or order of the High Court, is expressly declared to be final.[152]

Criminal suit

8.2.10 Hearings take place at first instance either at a Magistrates Court, Sessions Court or the High Court depending on the nature of the offence. Section 371(3) of CA 1965 states that proceedings for any offence against CA 1965 other than an offence punishable with imprisonment for a term exceeding three years may be prosecuted in a Magistrates Court. In the case of any offence punishable with imprisonment for a term of three years or more, it shall be prosecuted in the Sessions Court or in the High Court.

8.2.11 The Sessions Court may also impose any punishment authorised by CA 1965 notwithstanding that it is a greater punishment than the Sessions Court is otherwise empowered to impose.[153]

8.2.12 If the court of first instance is the Magistrates Court/Sessions Court, the aggrieved party may appeal to the High Court and thereafter the Court of Appeal (with leave). Such appeal shall be confined only to questions of law which have arisen in the course of the appeal or revision and the determination of which by the High Court has affected the event of the appeal or revision.[154] However, no leave of the Court of Appeal is required where the appeal is by the Public Prosecutor.[155]

8.2.13 If the Court of first instance is the High Court, the aggrieved party may appeal to the Court of Appeal and thereafter the Federal Court. An appeal to the Federal Court in this instance is as of right[156] and may lie on a question of fact or a question of law or a question of mixed fact and law.[157]

[147] Section 90 of Subordinate Courts Act 1948.
[148] Section 65(1)(b) of Subordinate Courts Act 1948.
[149] Subordinate Courts (Amendment) Act 2010.
[150] Section 28 of Courts of Judicature Act 1964.
[151] Court of Appeal Practice Direction No. 2 of 1996.
[152] Section 68 of Courts of Judicature Act 1964.
[153] Section 371(5) of CA 1965.
[154] Section 50(2) of Courts of Judicature Act 1964.
[155] Section 50(3) of Courts of Judicature Act 1964.
[156] Section 87(1) of Courts of Judicature Act 1964.
[157] Section 87(3) of Courts of Judicature Act 1964.

QUESTION 9

9. Foreign corporations

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

9.1 A "foreign company" is defined[158] as:

(a) a company, corporation, society, association or other body incorporated outside Malaysia; or

(b) an unincorporated society, association or other body which under the law of its place of origin may sue or be sued, or hold property in the name of the secretary or other officer of the body or association duly appointed for that purpose and which does not have its head office or principal business in Malaysia.

9.2 A foreign corporation may be wound up in Malaysia as an unregistered company[159] provided that the principal place of business of the company in Malaysia shall for all the purposes of the winding up be the registered office of the company.[160]

9.3 Section 332(1) of CA 1965 states the duties of every foreign company desiring to establish a place of business or to carry on business within Malaysia to lodge with the Registrar for registration:

(a) a certified copy of the certificate of its incorporation or registration in its place of incorporation or origin or a document of similar effect;

(b) a certified copy of its charter, statute or memorandum and articles or other instrument constituting or defining its constitution;

(c) a list of its directors containing similar particulars with respect to its directors as are by this Act required to be contained in the register of the directors, managers and secretaries of a company incorporated under this Act;

(d) where the list includes directors resident in Malaysia who are members of the local board of directors, a memorandum duly executed by or on behalf of the foreign company stating the powers of the local directors;

(e) a memorandum of appointment or power of attorney under the seal of the foreign company or executed on its behalf in such manner as to be binding on the company and, in either case, verified in the prescribed manner, stating the name and address of one or more persons resident in Malaysia, not including a foreign company, authorised to accept on its behalf service of process and any notices required to be served on the company;

(f) (Deleted by Act A616); and

(g) a statutory declaration in the prescribed form made by the agent of the company.

9.4 An "agent" of the company, defined as a person named in a memorandum of appointment or power of attorney lodged under CA 1965 or under any corresponding previous written law:[161]

(i) shall be answerable for the doing of all such acts, matters and things as are required to be done by the company by or under CA 1965; or

(ii) be personally liable to all penalties imposed on the company for any contravention of CA 1965 unless he satisfies the court hearing the matter that he should be not so liable.[162]

9.5 Winding up of foreign companies

9.5.1 The provisions with respect to winding up of a domestic company by the court shall apply to a foreign company (see para 9.2) and the court or liquidator may exercise any powers or do any act in the case of a foreign company which might be exercised or done by it or him in winding up companies.[163]

9.5.2 A foreign corporation may be wound up in Malaysia notwithstanding the fact that it is being wound up, or has been dissolved, or has otherwise ceased to exist as a company under or by virtue of the laws of the place under which it was incorporated.[164]

9.5.3 No unregistered company may be wound up voluntarily.[165]

9.5.4 An unregistered company may be wound up if:[166]

(a) it is dissolved or has ceased to have a place of business in Malaysia, or has a place of business in Malaysia only for the purpose of winding up its affairs, or has ceased to carry on business in Malaysia;

[158] Section 4 of CA 1965.
[159] Section 314(1) of CA 1965.
[160] Section 315(1)(a) of CA 1965.
[161] Section 330 of CA 1965.
[162] Section 333(2) of CA 1965.
[163] Section 314(2) of CA 1965.
[164] Section 315(3) of CA 1965.
[165] Section 315(1)(b) of CA 1965.
[166] Section 315(1)(c) of CA 1965.

(b) it is unable to pay its debts;

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

9.5.5 An unregistered company shall be deemed to be unable to pay its debts if:[167]

(a) a creditor by assignment or otherwise to whom the company is indebted in a sum exceeding RM500.00 then due has served on the company a demand under his hand requiring the company to pay the sum so due and the company has for three weeks after the service of the demand neglected to pay the sum or to secure or compound for it to the satisfaction of the creditor;

(b) any action or other proceeding has been instituted against any member for any debt or demand due/claimed to be due from the company or from him in his character of member, and notice in writing of the institution of the action or proceeding has been served on the company and the company has not within ten days after service of the notice paid, secured/compounded for the debt or demand, or procured the action or proceeding to be stayed, or indemnified the defendant to his reasonable satisfaction against the action or proceeding and against all costs, damages and expenses to be incurred by him;

(c) execution or other process issued on a judgment, decree or order obtained in any court in favour of a creditor against the company, any member or any person authorised to be sued as a nominal defendant on behalf of the company is returned unsatisfied; or

(d) it is otherwise proved to the satisfaction of the court that the company is unable to pay its debts.

9.5.6 Section 316 of CA 1965 provides that:

(1) On an unregistered company being wound up every person shall be a contributory:

(a) who is liable to pay or contribute to the payment of:

(i) any debt or liability of the company;

(ii) any sum for the adjustment of the rights of the members among themselves; or

(iii) the costs and expenses of winding up; or

(b) where the company has been dissolved in the place in which it is formed or incorporated, who immediately before the dissolution was so liable, and every contributory shall be liable to contribute to the assets of the company all sums due from him in respect of any such liability.

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' Management Liability Insurance

Directors and officers may take out Directors' and Officers' Management Liability Insurance to protect the directors and officers against personal liability which may arise in connection with the issues raised in Questions 1-9 above. The company and directors/officers may jointly pay the premiums. This insurance coverage provides independent protection to directors and officers personally and also reimburses companies for costs incurred in defending the directors and officers.

10.2 Indemnity

At common law, a director as agent or trustee of a company is entitled to indemnity for acts carried out on behalf of the company where he is acting within the powers conferred upon him.

10.2.1 However, the scope of indemnities a company can make available to a director is restricted by section 140 of CA 1965. Any provision (whether contained in the articles or in any contract with a company or otherwise) for exempting any officer or auditor of the company from, or indemnifying him against, any liability which by 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.[168]

10.2.2 However, notwithstanding the above, a company may, pursuant to its articles or otherwise, indemnify any officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in favour or in which he is acquitted or in connection with any application in relation thereto in which relief is under CA 1965 granted to him by the court.[169]

[167] Section 315(2) of CA 1965.
[168] Section 140(1) of CA 1965.
[169] Section 140(2) of CA 1965.

QUESTION 11

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

11.1 Generally, directors do not owe a fiduciary duty to the company's creditors. However, where a company is insolvent or nearing insolvency, the creditors are to be seen as having a direct interest in the company and that interest cannot be overridden by the shareholders. Nevertheless, this restriction does not, in the absence of any conferral of such a right by statute, confer upon creditors any general law right against former directors of the company to recover losses suffered by those creditors.[170]

11.2 A claim by a liquidator for damages for breach of duties may arise where the directors incur further credit which cannot be satisfied in full when due, and which leads to an inability to satisfy the claims of other creditors in full.

11.3 A reckless incurring of credit by directors during the "twilight period", without proper consideration as whether the company can make full repayment, may also lead to disqualification of directors. To prevent personal liability or vulnerability to disqualification proceedings, a director should not incur credit during the "twilight period", unless, following proper consideration, as to whether he is satisfied that there is a reasonable prospect that the credit can be discharged when due.

[170] Sycotex Pty Ltd v Baseler & Ors [1994] 12 ACLC 494.

NETHERLANDS

QUESTION 1

1. Twilight: when and how long?

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 General remarks on insolvency proceedings in the Netherlands

For companies in the Netherlands, there are two types of insolvency proceedings: suspension of payments (*surseance van betaling*) and bankruptcy (*faillissement*). Insolvency procedures are governed by the Dutch Civil Code (*Burgerlijk Wetboek*) (DCC), the Dutch Bankruptcy Act 1896 (*Faillissementswet or Fw*) (DBA) and, in case of cross-border insolvency cases, the EU Insolvency Regulation (31 May 2002).

The purpose of suspension of payments is to give a debtor an opportunity to reorganise its business and prevent liquidation of the company. Only a debtor may apply for suspension of payments, but there is no legal obligation to do so.[1] A company can request suspension of payments if it foresees it will not be able to pay all its creditors having due and payable claims. As long as the request is properly submitted to the competent court, a provisional suspension of payments is immediately granted. On granting a suspension of payments, the court will appoint one or more administrators (*bewindvoerder*) and a supervisory judge (*rechtercommissaris*). During the suspension of payments, unsecured creditors may no longer have recourse against the debtor. The debtor may pay its creditors, but only if payments can be made to all creditors, in proportion to their respective claims[2]. During the suspension of payments, directors retain their authority to represent the company, but the co-operation of the administrator is required[3].

The purpose of bankruptcy is to liquidate an insolvent company, although a going-concern sale of the assets is common. Bankruptcy proceedings can be initiated by the debtor, by one or more creditors (including the tax authorities) or by the public prosecutor.[4] The court will declare a company bankrupt if the facts and circumstances show that the company is in a position that it has ceased to pay its debts. The case law has established that “ceased to pay its debts” implies that the debtor has at least one due and payable debt, and two or more creditors. The use of the word “position” furthermore presumes some duration of the period in which the debtor has ceased to pay its debts, although the Dutch High Court (Hoge Raad) has stated that the requirement of a certain period doesn’t follow from the DBA. Therefore, all circumstances of the case are relevant to deciding if this situation has arisen. On declaring a company bankrupt, the court will appoint one or more trustees (curator) and a supervisory judge (R-C).[5] From midnight (00.00 hours) at the start of the day on which the bankruptcy is declared, the directors lose the authority to dispose of the company’s assets.[6]

A distressed company is not legally obliged to apply for suspension of payments or bankruptcy, but a director risks incurring personal liability if he or she allows an insolvent company to remain in business. During suspension of payments and bankruptcy, the task of the supervisory judge is to supervise the insolvency proceedings.[7] During suspension of payments, the supervisory judge merely has an advisory role. During bankruptcy, a number of actions and juridical acts (*rechtshandelingen*) conducted by the trustee require the supervisory judge’s consent. For example, the permission of the supervisory judge is required for the private sale of assets[8], the termination of mutual agreements, rental agreements and employment agreements[9] and the decision to continue the debtor’s business[10].

[1] Art. 214 DBA.
[2] Art. 233 DBA.
[3] Art. 228 DBA.
[4] Art. 1 DBA.
[5] Art. 14 DBA.
[6] Art. 23 DBA.
[7] Art. 64 DBA.
[8] Art. 101 DBA and Art. 176 DBA.
[9] Art. 68(2) DBA and Art. 37, 39, 40 DBA.
[10] Art. 98 DBA.

1.2 What is the length of the period ending with formal insolvency proceedings?

Unlike in certain other European countries, there is no formal twilight period in the Netherlands, ie a period prior to bankruptcy during which the acts of a company may be questioned or undone. Nevertheless, the law does grant the trustee, creditors and the tax authorities tools to hold the directors liable for losses caused by mismanagement and to undo transactions performed during the period prior to the adjudication of bankruptcy.

With regard to director's liability, the period of three years prior to bankruptcy is important[11]. The period during which transactions are most vulnerable to being challenged by a trustee is the last year preceding the bankruptcy, because of a statutory evidentiary presumption of awareness that the transaction will prejudice the creditors' interest [12] This possible ground for annulment is the so-called "*actio pauliana*".

1.3 General remarks on the concept of "*actio pauliana*"

The Dutch concept of "*actio pauliana*" resembles the concepts of "fraudulent transfer" and "preferred mandatory transaction" known in other jurisdictions.[13] The *actio pauliana* is the means available under Dutch law for declaring transactions that were detrimental to the bankrupt estate null and void.

Two general distinctions must be made. First of all, the DBA contains specific provisions, based upon the *actio pauliana* as defined in the Dutch Civil Code, that provide an exclusive action for the trustee to commence an *actio pauliana* after adjudication. In general therefore, the *actio pauliana* may be relied on by creditors outside the bankruptcy, and by the trustee during bankruptcy. Second, the trustee may use the *actio pauliana* also in cases where a mandatory legal act has been performed. The scope of the *actio pauliana* during the bankruptcy itself is therefore wider as it is not limited to voluntary transactions, but also includes the possibility of invalidating obligatory transactions.

The requirements for nullification of the legal act in case of a voluntary legal act differ depending on the nature of the legal act; two types of acts may be distinguished: the legal act without consideration, and the legal act with consideration.

In the case of a legal act with consideration, a trustee may invalidate the voluntary legal act if he or she establishes that the following four requirements have been met: (i) there was a voluntary juridical act for a consideration (*rechtshandeling*); (ii) the transaction was detrimental to the creditors; (iii) the debtor was or should have been aware of the fact that the transaction would prejudice the creditors' interest; and (iv) the counterparty of the debtor was or should have been aware of the prejudice.

In the case of the legal act without consideration, the requirement of knowledge or expected knowledge (ie 'should have known') only applies to the debtor.

A statutory presumption that the debtor and the counterparty knew or should have known the transaction was prejudicial to creditors applies where the voluntary transaction was performed within one year before the bankruptcy adjudication and the transaction belongs to one of the following categories: (a) transactions where the value of the payment the debtor received was substantially less than the estimated value of the assets given; (b) the payment of debts, or the granting of security for debts which are not due and payable yet; or (c) transactions with relatives or affiliated parties. The presumption of knowledge is rebuttable.

Only in exceptional circumstances may a trustee annul a mandatory transaction. Annulment of such a transaction is possible in cases where payment was made, or security was granted to a creditor who knew a petition for bankruptcy was pending, or where the trustee establishes that payment was made or security was granted as a result of consultation between the debtor and creditor, with the purpose of discriminating in favour of the named creditor[14] From the case law, it follows that "consultation" is to be interpreted restrictively. Consultation implies conspiracy between the debtor and his counterparty to defraud the other creditors and the intention, not only of the creditor, but also of the debtor, to discriminate in favour of the creditor.[15]

For an *actio pauliana* commenced by a trustee to become effective, an extra-judicial statement by the trustee will suffice.

1.4 Does the feasibility of a claim based on *actio pauliana* and director's liability depend on whether a formal insolvency procedure is instituted?

The three-year period during which a director's acts may lead to a director being liable for the bankruptcy deficit on the basis of articles 2:138/248 DCC is calculated from the moment of the adjudication of bankruptcy.[16] The one year period in which the trustee may benefit from the statutory evidentiary presumption to annul a legal act on the basis of the *actio pauliana* is also calculated from the moment of this adjudication.

The *actio pauliana* which may be commenced by creditors, as mentioned earlier, also applies outside bankruptcy. Creditors have the option of annulling any non-obligatory juridical act if a creditor is able to establish that both the debtor and its counterparty knew, or should have known, that the specific transaction would be detrimental to one or more creditors[17]. Creditors lose this ground for annulment as soon as a company is declared bankrupt. In the case of bankruptcy, only the trustee may annul transactions on the basis of *actio pauliana*.[18]

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[11] Art. 2:138/248 DCC.
[12] Art. 43(1) DBA.
[13] Peter J.M. Declercq, Netherlands Insolvency Law, the Netherlands Bankruptcy Act and the Most Important Legal Concepts, (2002) T.M.C. Asser Press, The Hague; see for an extensive elaboration of the "*actio pauliana*" in English, pages 135-150.
[14] Art. 47 DBA.
[15] Dutch Supreme Court, 24 March 1995, NJ 1995,628.
[16] Art. 2:138(6)/248(6) DCC.
[17] Art. 3:45 DCC.
[18] Art. 49 DBA.

For liability, a distinction must be made between "internal liability" and "external liability". The internal liability is the liability of the director(s) of the company towards the company (legal entity) and is shaped in article 2:9 of the Dutch Civil Code. External liability, however, constitutes liability in respect of creditors, the trustee, or other third parties, including the liability in tort. Liability towards the company and the external liability in tort are not restricted to insolvency, but have a much wider scope. The different liabilities are explained in paragraph 2 below.

1.5 Is the nature of the transaction relevant with respect to the concept of "*actio pauliana*"?

The nature of the transaction regarding the *actio pauliana* commenced by the trustee is not relevant to the risk of nullification of pre-bankruptcy transactions.[19] The nature of the transaction may be relevant to deciding if the transaction was performed to fulfil a legal duty or not. However, the presence of a legal obligation to perform the transaction is decisive, not the nature of the legal act performed. As explained above in paragraph 1.3, a voluntary transaction is more vulnerable to annulment than a mandatory transaction.

According to Dutch case law and legal doctrine, the following transactions are inter alia included in those considered voluntarily undertaken: granting security for a debt when the loan documentation does not require additional security; selling assets and setting off the purchase price against the debt; payment of a debt in kind instead of in money without a contractual obligation to do so; payment of a debt which is not yet due and payable; and the act of concluding a settlement agreement containing an agreement on the payment of wages in arrears.

1.6 With respect to the " *actio pauliana*", is it relevant whether the party to the transaction is connected to or associated with the company?

If a party to the transaction is connected to or associated with the debtor-company it will be easier for the trustee to annul the transaction on the basis of *actio pauliana*. For annulment, it is necessary that both the debtor-company and its counterparty knew or should have known that the transaction would prejudice the interests of the creditors. To ease the burden of proof on the trustee, Dutch bankruptcy law provides for a statutory presumption of knowledge if the transaction was performed within one year of the declaration of bankruptcy and provided it can be established that the transaction falls in certain categories, one of which is that the transaction was entered into by the debtor-company with certain relatives or related parties.[20] The statutory presumption of knowledge only applies to non-obligatory transactions.

1.7 Will other circumstances lengthen or shorten the "twilight" period?

Even though there is no formal twilight period in the Netherlands, there are circumstances that influence the time when a debtor should petition for bankruptcy. The substantiation of the concept "knew or ought to have known", regarding the *actio pauliana* commenced by the trustee, is influenced by the moment in time when the bankruptcy and the shortfall of assets could have been anticipated with a reasonable degree of probability by the debtor and the other party.[21] Therefore, the adjudication itself is important for the one-year statutory evidentiary presumption regarding the concept of "knew or ought to have known", while the aforesaid moment of anticipation substantiates this concept. Directors are vulnerable to being held liable for losses of creditors if they allow the company to enter into obligations knowing that it is very likely that the company will not be able to meet its obligations and that the creditors will not recover the losses they will suffer as a consequence. According to Dutch case law, directors are personally liable for these losses. This is referred to as "Beklamel liability" (see paragraph 2.5 below). On the other hand, Dutch case law stipulates that directors are not only allowed to continue to carry on the business of the company, but actually have an obligation to do, as long as a successful reorganisation is still feasible.[22]

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 remarks

Most actions which potentially give rise to liability for directors will be sanctioned by more than one statute, each with different actions and legal consequences. Also, it is difficult and artificial to distinguish and arrange these actions into specific groups, because under Dutch law the importance of the circumstances of the case prevails.

[19] Dutch Supreme Court, 3 December 2010 (Curatoren Air Holland/ Stichting Garantiefonds).
[20] Art. 43, under 4, DBA.
[21] Dutch Supreme Court, 22 December 2009 (ABN Amro/Van Dooren q.q. III).
[22] Court of Amsterdam, 22 August 2001, JOR 2001/212.

Instead of describing the different actions undertaken by directors, for the above reasons, the articles upon which liability of directors may be based will be discussed, including the grounds and the legal effects.

As mentioned earlier (paragraph 1.4), a rough distinction can be made between the liability to the company, also known as "internal liability"[23], and the liability to a third party, the "external liability"[24]. The latter group includes the liability to the bankruptcy estate, as well as the liability for a wrongful act or tort[25].

In order to gain a better view of the risks of director liability it is useful to have a basic understanding of Dutch company law. In the Netherlands, there are generally two types of companies: the limited liability company (*Naamloze Vennootschap or NV*) and the private limited liability company (*Besloten Vennootschap or BV*). Both types of companies have capital requirements and have capital divided in shares: the main difference between the two is that the articles of association of a private limited liability company must contain a clause restricting the free transferability of its shares.

Under the current Dutch law, small companies may have a management structure only comprising a board of directors. However, most large companies have a two-tier corporate governance structure with a board of directors and a board of supervisory directors. Large companies meeting the following three criteria: (i) having at least one hundred employees; (ii) having a works council, as required by law; and (iii) having an issued capital of at least 16 million are obliged to adopt the two-tier system[26]. Directors represent the company in its dealings with third parties and have a duty to manage the company. The supervisory directors have a duty to supervise the directors, and their actions are not binding on the company. In March 2008, a Bill was introduced proposing a one-tier corporate governance structure for all Dutch companies which entered into effect on 1 January 2013. This Bill creates the possibility for companies to choose a one-tier board, instead of the classic two-tier boards under Dutch company law. The articles of association of a company will stipulate that a company may have a board of directors consisting of executive directors and non-executive directors[27].

2.2 Internal liability

Internal liability may occur if a director does not properly perform the assigned duties or violates the articles of association of the company. As a general rule, a managing director is only liable for improper performance of duties in the case of serious negligence, taking into account all relevant circumstances. The criterion developed by the Dutch Supreme Court is whether it is possible to attribute serious blame to the director.[28] The possible attribution of serious blame depends on all the circumstances of the case.

If the annual general meeting has discharged the board of directors, the trustee will no longer be able to bring an action against the directors based on the internal liability. However, the discharge will be confined to facts which were disclosed to the annual general meeting.

The rules for internal liability are to be changed and expanded in future legislation. The modified article 2:9 DCC, which already has been passed by the Dutch legislative organs, contains some minor changes to the grounds for liability.[29] The effects of these modifications are not entirely clear and therefore practice and case-law will need to clarify their impact.

Furthermore, as a result of other major changes in Dutch company law, a new article 2:216 of the Dutch Civil Code expands the grounds for internal liability, e.g. the liability against the company.[30] The board of directors is liable towards the company for payments to stockholders in breach of a newly introduced liquidity and insolvency test. This test regulates the maximum payments to stockholders. The directors are jointly and severally liable for the shortage due to the payments made. Stockholders which accepted the payments in bad faith, are obliged to repay the amounts received to the company. The liability of the director will be reduced equally by these payments.

2.3 Characteristics of the liability

(i) Liability is civil.

(ii) The directors are personally and severally liable for the losses suffered by the company.

(iii) Each director will be liable for the losses suffered by the company. This liability is based upon a collective liability of the board. If a matter pertains to the field of activities of two or more directors, each of them will be jointly and severally liable for the failure unless one of them proves that the mismanagement was not attributable to him and that he was not negligent in taking measures to prevent or limit the consequences. After payment of the total sum, the director may have recourse against the other directors based upon the Dutch Civil Code. He will be liable for that part of the damages which concerned his actions.

(iv) The liability based upon article 2:9 of the Dutch Civil Code is not limited to a certain period of time, although one should take into account the limitation period, discussed under paragraph 8.

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23 Art. 2:9 DCC.
24 Art. 2:138/248 DCC.
25 Art. 6:162 DCC.
26 Art. 2:153/263 DCC.
27 Art. 2:129a/239a DCC.
28 Dutch Supreme Court, 10 January 1997,., NJ 1997, 360 (Staleman/Van de Ven)
29 Legislative Proposal ""Wijziging van boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van regels over bestuur en toezicht in naamloze en besloten vennootschappen"", Kamerstukken 31763.
30 Legislative Proposal "Wet vereenvoudiging en flexibilisering bv-recht", Kamerstukken 31058.

(v) The general meeting of shareholders may discharge a director or the board of directors at the end of the book year upon acceptance of the annual accounts. Such a discharge may prevent liability under article 2:9 DCC. However, the discharge does not apply to facts that were not disclosed in the annual accounts. Also, the defence of a director and major shareholder claiming that the shareholders' meeting knew of fraudulent acts performed by the director which were not written down in the shareholders' resolution, was not accepted by the Dutch Supreme Court.[31] A discharge decision may also be invalidated if it is considered to be in violation of the principle of reasonableness and fairness[32]. However, case law indicates that even if a director has deliberately prejudiced the company's interest, the decision to discharge the director is not contrary to the principle of reasonableness and fairness.[33]

2.4 External liability against the bankruptcy estate

External liability towards the bankruptcy estate arises if it can be established that the directors have mismanaged the company and that the mismanagement was an important cause of the bankruptcy. If directors have failed either in their obligation to keep financial records in accordance with article 2:10 DCC or if their company has not published its annual accounts in time in accordance with article 2:394 DCC, two statutory presumptions apply. First, there is an irrefutable presumption that the board of directors has performed its duties improperly. Second, there is a rebuttable presumption that the violation of the obligation was an important cause of the bankruptcy.

The liable director is not allowed to set off debts he owes the company following liability against existing debts of the company owed to him.[34]

2.5 Characteristics of the liability

(i) Liability is civil.

(ii) Directors are personally and severally liable for the bankruptcy deficit in the case of external liability under articles 2:138/248 DCC. The court will reduce the amount if the sentence is considered excessive in relation to the degree of mismanagement by the respective director[35].

(iii) As is the case with the internal liability, an exception can be made for an individual director if he or she is able to establish that the mismanagement of the board of directors is not attributable to his performance[36].

(iv) For liability under articles 2:138/248 DCC, a period of three years applies before the formal bankruptcy declaration.

(v) If a claim is based on articles 2:138/248 DCC, the defence could be that a director or the board of directors may have mismanaged the company, but that the mismanagement has not caused, or at least is not the main cause of, the bankruptcy order. If the directors are able to establish that other circumstances, eg the economic situation, has caused the bankruptcy, the directors will not be held liable on the basis of this provision. A decision to discharge the director will not prevent liability under articles 2:138/248.

2.6 External liability: torts

A director is liable in tort if: (i) there was an act or omission that infringed someone's rights, violated a legal obligation or breached a duty of care; (ii) the act or omission can be attributed to the director; (iii) a third party, or third parties, suffered loss or damage; and (iv) it can be established that the act or the omission was the cause of the loss or damage. In particular, a misleading representation in the prospectus and prejudice to creditors can result in tort liability.

Under article 6:194 DCC, a managing director can be liable towards third parties for a misleading representation of the financial position of the company in a prospectus. The relevant rules shift the burden of proof with respect to the misleading presentation to the issuer of the prospectus.

As far as prejudice to creditors is concerned, it follows from the case law that a managing director is liable under article 6:162 DCC if the managing director entered into a contract on behalf of the company knowing, or having reason to know, that the company would not, or would not within a reasonable time, be able to fulfill its obligations and would not have assets against which the creditor could take recourse[37]. The turning point, or reference date, is the day on which a director knew, or should have known, bankruptcy was unavoidable. To prevent liability in tort, a director should inform the company's creditors about it in a timely manner.

The Supreme Court has ruled that a managing director can limit this form of liability by making the creditors aware in a timely manner of the financial situation or by filing a request for suspension of payments in a timely manner[38]. The Supreme Court has acknowledged that this places directors in a dilemma. Informing creditors too early of a looming state of insolvency will make bankruptcy inevitable; whereas informing creditors too late may lead to personal liability. For this reason the Supreme Court has ruled that, to be safe, the date of the turning point is to be the date on which the director must have known bankruptcy was unavoidable.[39]

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31 Dutch Supreme Court 25 June 2010, JOR 2010, 227 (De Rouw/Dingemans)
32 Art. 2:8 DCC.
33 Dutch Supreme Court 20 October 1989, NJ 1990, 308 (Ellem Beheer/De Bruin); and Court of Appeal of Den Bosch, 11 September 2007, JOR 2007, 264.
34 Dutch Supreme Court 18 September 2009, JOR 2010/29 (Simoca).
35 Art. 2:138/248 under 2 DCC.
36 Art. 2:138/248 DCC
37 Dutch Supreme Court, 6 October 1989, NJ 1990, 286, (Beklamel).
38 Dutch Supreme Court, 21 December 2001, RvdW 2002/6.
39 Dutch Supreme Court, 21 December 2001 (SOBI/Hurks), JOR 2002/38, as recently confirmed by the Court of Appeal of The Hague, 16 September 2008, LJN BF 4107.

Finally, a former director may be liable under article 6:162 towards third parties as a result of contracting with the company after bankruptcy because, even in this circumstance, a special duty of care exists towards the insolvent company. In the specific case before the Dutch Supreme Court, the agreement between the director and the insolvent company turned out to be very profitable for the director, profits that could have been earned by the insolvent company had it been advised correctly by its former director.[40]

2.7 Characteristics of the liability

(i) Liability is civil.

(ii) If the director is liable in tort, the director will be liable for the loss and damage suffered by the creditor(s), as a consequence of the wrongful act.

(iii) Liability in tort attaches to the individual director and there is no collective liability. Serious blame must be proved against the director individually.

(iv) Liability under article 6:162 is not limited to a specific period, save for the statutory limitation periods.

(v) The defences available will vary according to the grounds of the accusation. If the tort is based on a statutory "*lex specialis*", like article 6:194 DCC, the defences will depend on the possibilities provided for by this legal provision. If the claim is however based on the general doctrine of Dutch tort, the director must contest with good reason the different requirements for tort, namely the violation of a legal obligation or breach of a duty of care, the causality between the damage and the act or omission, the existence of damage, and the purport of the legal obligation or duty breached.

2.8 Liability towards the tax authorities

The director may be liable to the tax authorities for due taxes if he fails to give notice to the tax authorities of the inability to pay taxes.[41] This liability is the result of a legal presumption and may be contradicted by the director. The director will be liable for the total amount of tax owed by the company. Liability will also arise if the legal entity is not paying taxes while having liquidity to do so, but chooses to put these resources to other use.[42]

2.9 Characteristics of the liability

(i) The liability is civil.

(ii) Directors are personally and severally liable for the tax debt of the legal person.

(iii) The liability is a collective liability. Directors may exculpate themselves. First, a director must prove that the failure to give notice was not his or her fault. Second, the director must prove that the failure to pay is not attributable to mismanagement committed by him/her. The court has no discretion to mitigate the liability.[43]

(iv) The Dutch tax authorities will examine the three-year period prior to the notice of default to show mismanagement, a pre-requisite of this liability.[44] If no notice of default has been given, this three-year period commences at the moment of default. As stated earlier, the director has to prove the default cannot be attributed to the mismanagement of the company during this period.[45]

(v) As stated under (iii) and (iv), the director has two routes of defence. When the notice of default was given correctly, he must contest the claims of mismanagement by the tax authorities. Where the notice was not given correctly, he must argue convincingly that the failure to give the notice cannot be attributed to his actions, and to prove that the failure to pay the taxes is not the result of mismanagement of the company.

2.10 Legal persons as directors

The liability of directors will be extended to the directors of another legal person, when the directors of that legal person are themselves legal persons.[46] This liability is jointly and severally. The directors may have recourse against the legal person of which they were directors, although the latter itself may have a claim on the directors based on internal liability. Finally, this liability only concerns the formal directors, and cannot be extended to the factual policy makers of the company.[47]

2.11 Characteristics of the liability

(i) The liability is civil.

(ii) Directors are jointly and severally liable for the claim against the directors of the legal person concerned.

(iii) The statutory provision contains no specific exculpation possibilities. The aim of this provision is to 'pierce through' the corporate structure to the actual person in charge of the company registered as statutory director. In other words the risk of liability always lies with the person responsible and not solely with the company or companies placed in between.

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[40] Dutch Supreme Court 11 februari 2011, JOR 2011,14.
[41] Art. 36 Collection of State Taxes Act 1990(CST)
[42] Dutch Supreme Court, 4 Februari 2011 JOR 2011/170.
[43] Dutch Supreme Court, 15 May 2009 , LJN BI3747.
[44] Art. 36(3) CST
[45] Art. 36(4) CST
[46] Art. 2:11 DCC
[47] Dutch Supreme Court, 28 April 2000, nr. C99/087, NJ 2000/411.

(iv) The time periods are the same as those on which liability of the initial directors is based.

(v) The law states that the liability must have arisen at the moment the legal person was a director of the other legal person. Therefore, a likely defence may be that at the moment the original liability arose, the legal person (and therefore its directors) was not (yet) a director of the other legal person.

2.12 Risk of criminal liability

In the case of fraudulent transactions, directors are subject to criminal prosecution. Criminal prosecution of companies and directors used to be rare, but in the last few years this process has been initiated quite a few times. Both companies and their directors may be prosecuted under the Dutch Penal Code (DPC), for example, for deliberately publishing annual accounts that contain irregular activities[48], falsification of correspondence[49] or deceiving the accountant[50]. A well-known example is the prosecution of the directors of Ahold, a criminal case that in the end was settled out of court. From Ahold and other case law, it is apparent that official directors and other managers risk criminal liability if it is found that they were in charge of the illegal transactions performed by the company and the formal director or manager knew, or should have known, that the transactions were illegal. If the director or manager is found guilty, the director faces imprisonment for a certain number of years (a maximum of six years for the publication of incorrect annual accounts and the falsification of correspondence and a maximum of four years for fraud) or a fine "in the fifth category", for which the maximum amount is €78,000 (Article 23 DPC)."

The Dutch Penal Code contains other specific provisions regarding acts committed before or during bankruptcy. Articles 340 to 344 contain provisions which regulate culpable and fraudulent bankruptcy. Article 347 of the Dutch Penal Code punishes by imprisonment or a fine the director that cooperated in or gave his permission to transactions in breach of statutory provisons or in breach of the articles of association, which act brought serious damage to the company. Finally, the Dutch Penal Code enables the court to remove a director from his office.[51]

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 Liability of others and differences in degree of liability

In addition to the directors, the internal liability also applies to members of the board of supervisory directors. The criterion for liability is the same as is the case with directors: if it is possible to attribute serious blame to the member of the board of supervisory directors. Of course, in interpreting this criterion, one must take into account the tasks of the board of supervisory directors. They will only be held liable if it is established that they breached their duty to properly perform the tasks assigned to them. For example, liability may occur if the members of the board of supervisory directors gave their permission for activities when they should have refused permission. The members of the board of supervisory directors are jointly and severally liable. To avoid liability, the member of the board of supervisory directors must prove that the mismanagement was not attributable to the member and that the member was not negligent in taking measures to prevent or limit the consequences.

In the case of the external liability concerning the bankruptcy estate, the group of persons that risk liability is larger. Like the managing directors of a company, members of the board of supervisory directors can be held liable on the basis of article 2:138/248 DCC, combined with article 2:149/259 DCC. Liability to the bankruptcy estate[52] is also a possibility for any (legal) person who has (partly) influenced the company's policy. The actual director (as opposed to the formal directors) risks the same liability as the formal directors, restricted to the shortfall of assets. The same grounds for exculpation apply.

The shareholders of a company may be liable towards the creditors. In the Netherlands, the main principle is that shareholders of a company are only liable up to the amount of the shares for which they have subscribed[53]. However, there may be exceptional circumstances in which shareholders may become liable for more than their shareholding, e.g. if they have had a serious influence on the company's policies and may therefore be deemed de facto managing director[54].

[48] Art. 336 DPC.
[49] Art. 225 DPC.
[50] Art. 326 DPC.
[51] Art. 349 DPC.
[52] Art. 2:138/248 DCC.
[53] Art. 2:80/191 DCC and art. 2:81/192 DCC.
[54] Art. 2:138/248 under 7 DCC.

The Dutch Supreme Court has ruled that, in the case of a parent company being the shareholder, the shareholder may, in its capacity as parent company, also be held liable in tort for the loss and damage suffered by creditors of the subsidiary. Also vulnerable to liability is a shareholder that had insight into, and control over, the policy of the subsidiary, that was considerable and to such an extent that the shareholder knew, or should have known, that new creditors would be prejudiced by the lack of recourse and yet, despite this knowledge, failed to protect the payment to be made to the subsidiary's creditors. A shareholder may further be liable to creditors if the shareholder has caused creditors to have the expectation (for example, by publishing something in the newspaper) that the shareholder would successfully reorganise the debtor-company as a consequence of which payment to all the creditors would be guaranteed. Other circumstances increasing the risk of the extended liability of a shareholder are: accepting pay-outs of dividends, thus leaving the company with insufficient reserves to continue its business; accepting security over most of the assets of the subsidiary, knowing that such a transaction would leave other creditors unpaid; and allowing the subsidiary to satisfy the claims of its creditors with the exception of one or a few specific creditors. In these cases the shareholder risks incurring liability for the loss and damage suffered.

Finally, the trustee may, on behalf of the estate, commence a so-called "Peeters/Gatzen"-action.[55] This action may be commenced against third parties, even though the company itself is not allowed to conduct legal procedures. The procedure is based on tort, committed by the third party, against the joint creditors. This restriction, the wrongfulness of the act against the joint creditors, is important in defining the authority of the trustee in commencing a procedure based on this kind of tort. The liability is restricted to the loss and damage suffered by the joint creditors.

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 Potential heads of challenge

The most important challenge for parties dealing with a financially unhealthy company is the risk that a transaction may be considered a fraudulent transaction, thus causing the nullification of the transaction by a trustee (action pauliana). As mentioned earlier, substantiating the concept "knew or ought to have known", in relation to an *actio pauliana* commenced by the trustee, is dependent on the moment in time in which the bankruptcy and the shortfall of assets were anticipated with a reasonable degree of probability by the debtor and the other party.[56] The risk of nullification is therefore considerable when dealing with companies in financial trouble, although one must keep in mind that this action is restricted to voluntary legal acts.

4.2 Available defences

To limit the risk of nullification, voluntary transactions, especially with affiliated parties, should be avoided. When dealing with this type of situation one should always be aware that a defence against possible actions brought by a future trustee in bankruptcy is the ability to prove that the creditors' interests were not prejudiced by the specific transaction or that the counterparty had no knowledge of the prejudice. Mandatory transactions will hardly ever be nullified.

QUESTION 5

5. Enforcement

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

5.1 Actions brought against directors

Action against directors may be brought by the trustee and other third parties who have suffered damage, most likely the creditors. The possibility for bringing an action against a director however is dependent on the nature and legal basis of the claim.

An action based on liability against the bankrupt estate may only be brought by the trustee.[57]

Actions based on tort may be brought by any person who claims to have suffered damages. If the bankrupt company does not have the right to bring a tort claim against a third party, the trustee by contrast still may bring a tort claim against the party. In the Netherlands, one of the main duties of a trustee is to serve the interests of the creditors of the bankrupt company. For that reason, a trustee may not, eg by bringing an action against a third party, represent the interests of only some of the creditors. A trustee has the right to bring a tort action against a third party for the losses suffered by creditors only if the trustee is able to establish that all creditors have suffered losses as a consequence of the wrongful act. In Dutch legal doctrine, this is referred to as a "Peeters/Gatzen claim".[58] The enforcement of this kind of claim is not the exclusive right of the trustee. Creditors may also bring a tort action against the directors and may do so at the same time as the trustee.[59]

[55] Dutch Supreme Court 14 Januari 1983 (Peeters q.q./Gatzen).
[56] Dutch Supreme Court 22 Decembre 2009 (ABN Amro/Van Dooren q.q. III).
[57] Art. 2:248 DCC.
[58] Dutch Supreme Court 14 January 1983, NJ 1983, 597 and Dutch Supreme Court 16 September 2005, NJ 2006, 311.
[59] Dutch Supreme Court 21 December 2001, NJ 2005, 96.

Shareholders may take action against the directors on the basis of tort. Furthermore, the Dutch Supreme Court has recently ruled that shareholders may also institute an action on the basis of internal liability.[60]

The tax authorities may start legal proceedings against directors (and de facto directors) if the bankrupt company has violated certain tax regulations.

QUESTION 6

6. Legal remedies

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

6.1 Offences and legal remedies

Offence	Remedy available
Liabilty based on 2:9 DCC	The director may be ordered to compensate for any damage caused by breach of his duty. If a full award of damages would lead to obviously unacceptable results, the court may reduce the amount of the damages.[61]
Liability based on 2:138 or 2:248 DCC	The director may be ordered to compensate for the shortage in the bankruptcy estate. The court has a discretionary competence to reduce the amount if it regards the amount to be excessive, given the nature and seriousness of the improper performance of duties by the Board of Directors, the other causes of the bankruptcy and the way in which the liquidation estate has been wound up.
Liability based on tort (article 6:162 DCC)	The court may order the director or other liable parties to compensate for all loss and damages caused by the tort. If the injured party requests, the court may grant compensation other than a sum of money.[62]
Liability based on (future) 2:218 DCC	The court may order the director to compensate the company for the amount of money which is paid out. This amount may be mitigated by payments received in bad faith which shall be paid to the company by the shareholders.
Culpable bankruptcy (340/342 DPC)	Imprisonment for up to one year and/or a fine of €78.000,- and/or discharge from office. Fraudulent bankruptcy (341/343 DPC) Imprisonment for up to six years and/or a fine of €78.000,- and/or discharge from office. Fraudulent cooperation (347 DPC) Fine up to €78.000,- and/or discharge from office.
Paulianic transactions (42 and 47 DBL)	Annulment of the transaction by the court or a declaratory decision affirming the validity of the extrajudicial annulment.
In default of payment of taxes (36 CST)	The court may order the director to pay the total amount of taxes;no mitigation possibilities.
Liability of directors of legal-person-directors (2)11 DCC)	The court will order the same remedy as was ordered against the directors based on the initial grounds for liability.

The civil remedies may be accompanied by different sorts of attachment, of which the most important ones are the attachment before judgment and attachment in execution. Also, the remedy may be a provisionally enforceable decision.

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?

[60] Dutch Supreme Court, 20 June 2008, LJN: BC 4959
[61] Article 6:109 DCC.
[62] Article 6:103 DCC.

7.1 Co-operation by directors

The Dutch Bankruptcy Law obliges managing directors and supervisory directors to provide the trustee and the creditor's committee with all information requested with respect to the company's business[63]. The case law indicates that the duty to provide information includes information not specifically requested if the director knows, or should know, that the information is relevant to the trustee[64]. Directors may not escape their obligation to provide information by relying on the right to remain silent.[65] The information which is provided by the director may not be used as evidence against the director in a subsequent criminal procedure.[66] The trustee can enforce cooperation by requesting the supervisory judge to order the director to appear in court to present evidence[67]. If a director remains reluctant to cooperate, the director may even be taken into custody[68]. Finally, not providing information may constitute an offence punishable under the Dutch Penal Code art 194 by a fine or imprisonment for a maximum of one year.

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 Limitation periods

The limitation period for relying on an *actio pauliana* is three years from the day the trustee in bankruptcy becomes aware of the preferred transaction[69].

With respect to director liability[70], the general limitation period applies, which is five years from the day on which the plaintiff discovers the facts or circumstances causing the liability[71], and no later than 20 years from the day on which the circumstances causing the liability occurred. However, if the person liable is still a director on the day on which the limitation period expires, there will be an extension of the time limit until six months after the director's resignation[72]. The same extension applies if the director deliberately conceals his or her liability to the company[73].

8.2 Availability of appeal

In all the various liability situations described above, appeal against the decision of a lower court is possible. The decision of the court at first instance may be appealed to the court of appeal within three months of the day of the court's decision[74]. After the decision of the court of appeal, one may lodge an appeal to the Supreme Court. However, the Supreme Court will only hear appeals on questions of law. The Supreme Court has no jurisdiction to investigate factual relationships and circumstances. The period for lodging an appeal with the Supreme Court is three months starting on the day of the decision of the court of appeal.

QUESTION 9

9. Foreign corporations

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

9.1 Actio Pauliana

On 29 May 2000, the Netherlands adopted the EU Insolvency Regulation (Council Regulation 1346/2000 on Insolvency Proceedings), which entered into force two years later, on 31 May 2002. Since that date the EU Insolvency Regulation has been directly applicable in all EU member states (except Denmark). The EU Insolvency Regulation does not govern the insolvency of companies that do not have their main centre of interest in the EU nor does it regulate the consequences of commencing insolvency proceedings in non-EU member states.

Under the EU Insolvency Regulation, the law applicable to insolvency proceedings and their effect is the law of the member state within the territory in which the proceedings are opened (*lex concursus*), which is the member state in which the company has its centre of main interest.

63 Art. 105 DBA.
64 Dutch Supreme Court, 15 February 2002, NJ 2002, 259.
65 Dutch Supreme Court, 20 February 1998, RvdW 1998, 54.
66 ECHR 17 december 1996, case nr. 43/1994/490/572.
67 Art. 105 DBA.
68 Art. 87 DBA.
69 Art. 3:52(1c) DCC.
70 Art. 2:9 DCC.
71 Art. 3:310(1) DCC.
72 Art. 3:320(1d) DCC.
73 Art. 3:320(1f) DCC.
74 Art. 339(1) Dutch Code of Civil Procedure.

According to Article 4(2)(m) of the EU Insolvency Regulation, the *lex concursus* applies to the question whether legal acts detrimental to all creditors are void, voidable or unenforceable. Article 13 of the EU Insolvency Regulation provides for an exception to Article 4(2)(m) of the EU Insolvency Regulation. Under Article 13, the *lex concursus* does not apply if the transaction is subject to the law of an EU member state (lex causea) other than the EU member state where the insolvency proceedings were opened; and that respective law does not allow the nullification of the fraudulent transfer in the relevant case. Therefore, a transaction can only be nullified if nullification is allowed by the *lex concursus* and the *lex causae*.

9.2 Actions based on tort

According to Dutch international private law, Dutch law applies to actions based on tort if the wrongful act took place in the Netherlands[75], the *lex loci delicti*, unless both parties agree on the applicability of another law. The place where the losses are suffered as a consequence of the tort is considered the place where the wrongful act took place. On 11 January 2009, the Law on Tort lost most of its relevance as on that date the European Regulation regarding non-contractual relations (Rome II) entered into force. Rome II applies to tort actions occurring after 11 January 2009 in all European countries (except Denmark). Under Rome II the principle of lex loci damni will apply, which means that the law of the country where the damage occurs will apply, irrespective of the place where the wrongful act took place. However, parties may still agree on the applicability of another law.

9.3 Actions based on articles 2:138 and 2:248 DCC

If a company is declared bankrupt in the Netherlands, the liability of formal and de facto directors for the bankruptcy deficit under articles 2:138 and 2:248 DCC applies to both companies subject to foreign law and companies subject to Dutch law (Conflict of laws act relating to Corporations and the act on formal foreign corporations). The question of what constitutes unmistakably improper management will be governed by the law applicable to the respective corporation (*lex societatis*)[76].

9.4 The liability of a legal person as director of another legal person

According to article 2:11 of the Dutch Civil Code, where a legal person is liable in its capacity as director of another legal person, also the persons who, at the moment on which liability arose, were directors of the first mentioned legal person, are jointly and severally liable. The Dutch Supreme Court decided that this rule also applies in the case of a foreign legal person being the director of a company governed by Dutch law. The relationship between this former legal person and its directors however is governed by the *lex societatis*.

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 D&O insurance in the Netherlands

In the Netherlands director's liability insurance is available. The insurance generally provides cover against both internal and external liability, including damages and the costs of litigation.[77]Liability insurance provides protection against all liabilities, including gross negligence, but liability for an intentional and malicious act is always excluded. Fines will be excluded in most policies.

All D&O insurances are written on a "claims made" basis. Practically all D&O insurances also will end in the event of bankruptcy, which may be problematic for the director who is confronted with claims made by the trustee or other third parties after formal bankruptcy. Directors and other insured officers may cover this risk by purchasing cover for claims made during a five year period after bankruptcy, eg the tail-coverage. Most insurance contracts contain a limited three month period in which the director or the trustee have to give notice of the wish to purchase this tail-coverage.

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[75] Article 3 of the Law regarding applicability of the Law on Tort.
[76] B. Wessels, Insolvency Law, Kluwer 2006, p. 75.
[77] A. Hendrikse, D.A.M. Van den heuvel,"bescherming tegen bestuurdersaansprakelijkheid in tijden van crisis", TvO, 2009, 4, p.128.

QUESTION 11

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

11.1 New credit during the "twilight" period

The twilight period is probably most difficult for banks. They are between a rock and a hard place. If the credit agreement is terminated too abruptly, a bank may be liable for the losses a company suffers as a consequence.

If a bank decides to continue a credit agreement, or to grant new credit, they may be liable to the creditors for having created the expectation that the business would be able to meet its obligations. Furthermore, new credit agreements, and especially new security arrangements, are vulnerable to being nullified on the basis of *actio pauliana*, as pointed out above. In principle, banks may grant new credit as long as they have justifiable confidence in the company's ability to survive. If the bankruptcy and the shortfall of assets could have been anticipated with a reasonable degree of probability at the moment the bank and the debtor contracted the new loan and security agreements, annulment of the agreement is very likely. The Dutch Supreme Court has decided that, to limit the risk of annulment, banks should conduct a sufficient inquiry into the justification of additional credit and security agreements. The depth of this inquiry depends on the circumstances of the case.[78] This means that banks must monitor all financial developments and are expected to analyse all available documents and information having regard to the probability of bankruptcy and a shortfall of assets.

While dealing with financially unhealthy companies, banks must avoid new transactions that put the bank in a better position (for example, a preferred or secured position) in a bankruptcy.

Managing directors, supervisory directors and shareholders risk liability for the losses suffered by creditors for obligations entered into when they knew, or should have known, that the company would not be able to fulfil the obligations. On the other hand, initiating insolvency proceedings when there is still a window of opportunity may also be wrong and unlawful. As long as there is a well prepared and documented business plan with a reasonable chance of successful reorganisation, entering into a new credit agreement should not normally result in personal liability. Hazardous transactions are those transactions that do little more than bring the respective shareholder or director into a better position, for example, by fulfilling obligations guaranteed by a shareholder or director.

[78] Dutch Supreme Court , 22 december 2009 (ABN AMRO/Van Dooren q.q. III).

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) insolvent transactions – that is, transactions having preferential effect (s.292) – 2 years

(b) voidable charges (s.293) – 2 years

(c) transactions at an undervalue (s.297) – 2 years

(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.

1.1.3 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

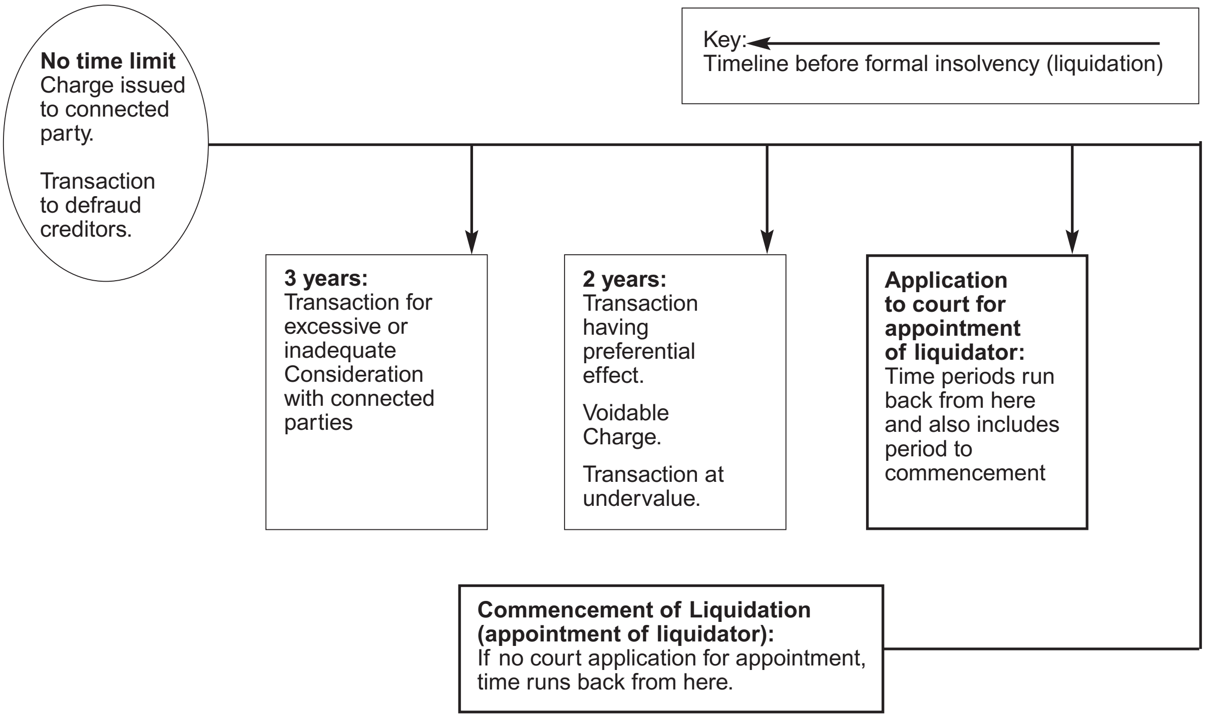
(b) an application is made to the court to put a company into liquidation and after the making of the application a liquidator is appointed by resolution of the shareholders of the company,

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 2007 also contains provisions which have the effect of avoiding, or requiring compensation to be paid in respect of, any transfer of property of other transactions made with intent to prejudice creditors. The transaction is challengeable at the instance of the person prejudiced or the liquidator of the company. There is no time limit. However the transaction cannot be avoided and no compensation will be payable if the property was transferred to a purchaser in good faith and for value who had no notice of the intention to prejudice creditors[2].

[1] References to the Act and all section references in this paper are to the Companies Act 1993, unless otherwise stated.
[2] Sections 344-350, Property Law Act 2007.

1.1.5 The following time line shows in graphic form the periods in respect of which certain types of transaction are vulnerable.



Personal liability of directors

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.

2.2 Reckless trading[6]

(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. The days of sleeping directors are long gone – directors must monitor the management of the company.[8]

A non-executive director may not be expected to have the same involvement in the company as an executive director[9].

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[5] *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 CA.

[6] Sectio 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.

[8] *Mason v Lewis* (2006) 9 NZCLC 264, 024.

[9] *AWA Limited v Daniels* (1992) 10 ACLC 993.

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;
- 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[10]

(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.[11] 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 authorizing 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 (s.56).

(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.

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[10] 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.

[11] Section 52 -
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).

(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 are not kept[12]

(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).

(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 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.

(iii) 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[13]

(a) (i) This liability applies to directors, "*de facto* directors", "shadow directors" and certain types of "deemed director".

(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.

[12] Sections 194 and 300.
[13] Section 301

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. Some of the statutory duties are duties of a fiduciary nature which accompany the office of director.

Duties owed to the company include:[14]

- to act in good faith in the best interests of the company[15] (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)

Duties owed to shareholders[16] 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.

The Companies Act 1993 imposes on directors no express duty to creditors. The duties not to trade recklessly or while insolvent (ss.135 and 136) are duties owed to the company (in loose terms the shareholders as a whole), not creditors (s.169). 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[17].

The duty to exercise care (section 137)

The standard of care that applies to directors when carrying out their 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 the director.

2.8 Carrying on business fraudulently[18]

(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.

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; or

(iii) with intent to defraud a creditor or creditors of the company, does anything that causes material loss to any creditor.

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14 Section 169.
15 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.
16 Section 169.
17 *Ukon Line Limited of Korea* [1998] 2 BCLC 485, and *Spies v The Queen* [2000] 8 HCA 43.
18 Section 380.

(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[19]

(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.

(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[20]

(a) A present or former director of a company in liquidation commits an offence if that person:

(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 is also automatically prohibited from being a director of or managing a company for 5 years without leave of the court (s.382).

(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.

[19] Section 273.
[20] Section 274.

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. Where a director is a mere conduit, they may still be personally liable if they intentionally aid or abet, or are directly or indirectly knowingly concerned in the deceptive conduct of the company[21].

(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, the Securities Markets Act 1988, the Securities Act 1978 (dealing with the issue of securities to the public) or the Takeovers legislation 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) been prohibited in another country from acting as a director, promoter or manager of a company.

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 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.

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).

[21] *Kinsman v Cornfields Ltd* (2001) 10 TCLR 342 (CA); *Newport v Coburn* (2006) 8 NZBLC 101,717 (CA).

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[22] 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.

3.2 *De facto* directors, shadow directors and deemed directors

3.2.1 The Companies Act 1993 contains a wide but not exhaustive definition of "director". Some categories of the definition apply only for the purposes of certain sections of the Act. Any person who is responsible for management decisions of the company could well 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.

[22] Section 126.

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.	
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 and past and present de facto directors	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; administrator; 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, administrators 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**
Transactions at an 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
Transactions prejudicing creditors (Property Law Act 2007)	Recipient of property (if knowledge of fraud or volunteer)	Return of property received (or compensation)
Knowingly assisting or receiving property or assets in breach	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 are insolvent transactions (that is, transactions 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) which constitute onerous property.

We look briefly at each head of challenge in turn. We also consider the status of unregistered security interests.

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:

(a) was unable to pay its due debts; or

(b) 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 the company entered into within 2 years 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 the section dealing with insolvent transactions (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 objective 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.

4.3 Insolvent transactions - transactions having preferential effect (section 292)

4.3.1 An insolvent transaction 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 a debt than the person would receive or would be likely to receive in the liquidation.

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. The onus of rebutting this presumption is on the counterparty to the transaction.

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 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 Until legislative changes in November 2007, a transaction could not be an insolvent transaction if it had occurred in the ordinary course of business. The meaning of "ordinary course of business" has been the subject of a considerable amount of judicial interpretation. This "defence" has now been removed. However, the defences provision (see Section 4.7 of this paper) has been amended to give protection to parties who are unaware that the company is or was about to become insolvent at the time of the transaction.

4.3.7 Where a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor and in the course of that relationship the level of the company's net indebtedness to the creditor is increased and reduced from time to time as a result of a series of transactions forming part of that relationship, for the purpose of establishing whether a transaction is an insolvent transaction, all the transactions forming part of the continuing business relationship are to be regarded as a single transaction (s.292(4B)). This provision, which came into force in November 2007, has yet to be judicially considered in New Zealand. However it is in all material respects identical to the equivalent provision in the Australian liquidation regime. The Australian courts have held that under that regime the liquidator is able to "cherry pick" the beginning of the period constituting the continuing business relationship (so long as it is within the 2 year period) – this will generally be the date of peak indebtedness - and establish whether the net effect of the series of transactions from that date until the continuing business relationship ends constitutes an insolvent transaction.

4.3.8 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 2 years before liquidation (see paragraphs 1.1.2 & 1.1.3) unless:

(a) (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[23]; or

(b) immediately after the charge was given the company was able to pay its due debts; or

(c) the charge is in substitution for a charge given before the 2 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.

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[24].

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.

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[23] 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.

[24] *Meo & Anor v The Official Assignee* (1987) 3 NZCLC 100,206, Court of Appeal.

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 (insolvent transactions– 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 (ss.296(3) and 239ACB)

4.7.1 Under section 296(3), even though a transaction may be a transaction at an undervalue, an insolvent transaction or a type of transaction referred to in Sections 4.4 – 4.6 of this paper, the courts must deny recovery by the liquidator of property or its equivalent value from the counterparty if the person from whom recovery is sought proves that when they received the property:

(a) they acted in good faith; and

(b) a reasonable person in their position would not have suspected, and they did not have reasonable grounds for suspecting, that the company was, or would become, insolvent; and

(c) they gave value for the property or altered their position in the reasonably held belief that the transfer of the property to them was valid and would not be set aside.

4.7.2 The test of good faith appears to be one of simple honesty[25]. 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[26].

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 goods or services and provide further credit.

4.7.4 The second limb of the defence under section 296(3) applies from November 2007 and in part has been included in the legislation as a result of the changes to the insolvent transaction provisions which came into effect at the same time (see paragraph 4.3.6). The provisions are now very similar to the equivalent Australian provisions, which should provide useful guidance to New Zealand practitioners and courts. However the Australian courts have grappled with the objective/subjective formulation of their equivalent to the second limb of the New Zealand provision.

4.7.5 Section 239ACB states that the insolvent transaction and voidable charge provisions do not apply to a transaction by a company in administration if the transaction is:

(a) carried out by or with the authority of the administration or deed administrator; or

(b) specifically authorised by the deed of company arrangement and carried out by the deed administrator.[27]

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.[28]

4.9 Transactions with the intent to prejudice creditors[29]

4.9.1 Where a company disposes of property with intent to prejudice creditors or by way of gift or at an undervalue, that transfer is challengeable at the instance of the persons prejudiced or the liquidator of the company.

4.9.2 The transaction can only be challenged if the company:

(a) was insolvent at the time, or became insolvent as a result, of making the disposition; or

(b) was engaged, or was about to engage, in a business or transaction for which the remaining assets of the company were, given the nature of that business or transaction, unreasonably small; or

(c) intended to incur, or believed, or reasonably should have believed, that the company would incur, debts beyond the company's ability to pay (section 346 Property Law Act 2007).

4.9.3 There is no statutory time limit.

4.9.4 If a court finds that the applicant has been prejudiced by the disposition of property, it can either vest the property in the company or require the recipient to pay reasonable compensation to the company (sections 348 and 350 Property Law Act 2007).

4.9.5 If the property is transferred to a person who acquires it for value in good faith without knowledge of the fact the disposition was caught by section 346, the property cannot be recovered, and the person cannot be required to pay compensation.

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[25] *Re Excel Freight Limited (In Liquidation)* (1999) 8 NZCLC 261,827.
[26] *Re Island Bay Masonry Limited (In Liquidation)* (1998) 8 NZCLC 261,751.
[27] See the Appendix for an explanation of the formal administration process.
[28] See generally discussion of directors duties in answer to question 2.
[29] Sections 344 to 350 Property Law Act 2007.

4.9.6 The court may decline to make a vesting or compensation order (or may make one with limited effect) against a person who received the property if that person proves that they received the property in good faith without knowledge of the fact the disposition was caught by section 346 and the person's circumstances have so changed since receipt of the property that it is unjust to order that the property be restored or reasonable compensation be paid – in either case in part or in full.

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; or (b) 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; or (c) a litigation right that, in the opinion of the liquidator, has no reasonable prospect of success or cannot reasonably be funded from the assets of the company. It does not include certain netting agreements or any contract of the company that constitutes a transaction under a netting agreement.[30] 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 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.

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 that property in the future.

4.11 Failure to register a security interest

4.11.1 The Personal Property Securities Act 1999 governs security interests in virtually all types of property other than ships longer than 24 metres and land. "Security interest", 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 Generally speaking, 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 and, in some circumstances, after certain creditors such as employees who are given a statutory preference. 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

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5 Enforcement

By who 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 in paragraph 5.3.2. 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.

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[30] See paragraph 4.2.4 for an explanation of this expression.

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 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 authorized 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**
Wrong doing (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
Breach of Fair Trading Act 1986	The affected creditors

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 authorizing 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).
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.

Offence	Remedy available
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.
Insolvent 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) repayment of money paid by the company; (d) the release or discharge of any security given by the company; (e) a person to pay the company such sums as represent the value of any benefits received by him from the company as a result of the transaction; (f) that security be provided for the discharge of any obligation imposed by or arising under the order; (g) 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 selfincriminating 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)2.

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.[31]

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.[32] 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.[33]

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 loss or damage, or the likelihood of the loss or damage, was discovered or ought reasonably to have been discovered.[34]

8.2 Appeals

8.2.1 Appeals are available from the decisions of the lower courts.

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 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 in New Zealand 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. An application can be made 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 in New Zealand 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 be vulnerable to attack under the provisions referred to in question 4.

[31] Section 4 Limitation Act, 1950.
[32] Section 4 Limitation Act 1950.
[33] Section 21(1) Limitation Act 1950.
[34] Section 43 Fair Trading Act 1986.

9.2.3 The court's power to appoint a liquidator in New Zealand to an overseas company is discretionary. In addition to any other grounds on which the court might generally decline to appoint a liquidator, the court is unlikely to appoint a liquidator unless the following three core requirements are fulfilled:

(a) there must be a sufficient connection with New Zealand which may, but does not necessarily have to, consist of assets within the jurisdiction;

(b) there must be a reasonable possibility, if a liquidation order is made, of benefit to those applying for the liquidation order; and

(c) one or more persons interested in the distribution of assets of the company must be persons over whom the court can exercise a jurisdiction.[35]

9.2.4 Where the overseas company has no assets in New Zealand, and where it is continuing to trade in its country of incorporation and elsewhere in the world, there would need to be exceptional circumstances for the court to order that the overseas company be placed in liquidation in New Zealand.[36]

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[37], with minor amendments.[38]

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.

9.3.3 The Insolvency (Cross-border) Act 2006 came into force on 24 July 2008. That Act implements the Model Law, with minor amendments. The Act empowers New Zealand courts to act in aid of or be auxiliary to foreign courts in relation to an insolvency proceeding in respect of which the foreign court has jurisdiction. In doing so, the New Zealand court may exercise the powers that it could exercise in respect of the matter had it arisen in its own jurisdiction.

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?

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, willful 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

(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.

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[35] *Socznia Gdanska v Latreefers* (No 2) [2001] 2 BCLC 116 (CA); *Real Estate Development Co* [1991] BCLC 210, 217.

[36] *Banco Nacional de Cuba v Cosmos Trading Corp* [2000] BCLC 813, 819 (CA).

[37] Adopted by the United Nations Commission on International Trade Law on 30 May 1997, and approved by the General Assembly of the United Nations on 15 December 1997.

[38] New Zealand Law Commission Report No. 52 Cross Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross Border Insolvency (1999).

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"[39]).

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 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*[40] 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.[41] Similar principles apply in New Zealand, where the courts have also, when considering whether directors have traded recklessly, drawn a distinction between the taking of legitimate and illegitimate business risks. When a company enters troubled financial waters the directors are required to make a "sober assessment" as to the company's likely future income and prospects, on an ongoing basis.[42]

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, that period is generally two years (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of how the vulnerability period is calculated).

11.2.2 Generally speaking, a transaction which an unconnected third party enters into with a company for "market value" during the twilight period, where the party has no reasonable grounds to suspect the company's insolvency, will not be struck down when 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 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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[39] 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.

[40] (1966) 115 CLR 666.

[41] 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.

[42] *Mason v Lewis* (2006) 9 NZCLC 264,024.

APPENDIX

Summary of NEW ZEALAND insolvency procedures and commercial issues

1 Introduction – probable law reform

1.1 Unlike many jurisdictions, New Zealand has no licensing or registration system for insolvency practitioners. There are very few restrictions on who can be appointed to act as a liquidator, receiver or administrator of a company. Such restrictions as there are generally relate to those who have a direct connection with the company or have provided professional services or had a continuing business relationship with the company within the previous two years. Persons who have been prohibited from being a director or manager of a company are also disqualified.

In August 2008, the then Government announced a decision to introduce a new negative licensing system for the insolvency profession. Given the small size of the profession in New Zealand, the Government saw a negative licensing system as a cost effective method of dealing with incompetent and poorly skilled insolvency practitioners.

As part of the reform it is proposed that the existing disqualification criteria will be tightened and the court's powers to replace insolvency practitioners in relation to particular assignments will be widened - the Registrar of Companies, creditors and other interested parties would be able to apply to the court to replace an insolvency practitioner who is not independent or has a conflict of interest.

The negative licensing regime would empower the Registrar of Companies to prohibit or ban a person from acting as an insolvency practitioner where the person lacks the relevant skills or competencies or is shown to have failed to perform statutory duties under the relevant legislation. Persons who have been banned would have a right of appeal to the court.

1.2 Reform in this area is the final step of a legislative program of significant reform to corporate and personal insolvency laws, enacted in 2006 and 2007, which came into force in late 2007 (in the case of the Insolvency (Crossborder) Act 2006, in July 2008).

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 2006 - 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.

(e) Insolvency (Cross-border) Act 2006 – implementing the UNCITRAL Model Law on Cross-Border Insolvency, with minor amendments.

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 3.9 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.

Voluntary administration

3.5 The board of a company can appoint an administrator if in the opinion of the directors voting for the resolution the company is insolvent or may become insolvent (that is, unable to pay its debts). The court can appoint an administrator on the application of a creditor, the liquidator (if the company is in liquidation), or the Registrar of Companies if the court is satisfied that the company is or may become insolvent and that an administration is likely to result in a better return for the company's creditors and shareholders than would result from an immediate liquidation of the company; or that it is just and equitable to appoint an administrator. A creditor who holds a charge over the whole or substantially the whole of the company's property may also appoint an administrator if the charge has become enforceable (provided the company is not already in liquidation).

3.6 The administrator is required to investigate the affairs of the company and report to creditors within prescribed time limits (these limits can be extended by the court). While the company is in voluntary administration, there is a moratorium period during which no creditor (except in limited circumstances a secured creditor with a charge over all or substantially all of the company's assets) can take any enforcement action against the company. At a "watershed" meeting, creditors vote on three options:

- a deed of company arrangement should be entered into between the creditors and the company, which may allow the continued operation of the company or an orderly wind down of the company's affairs.
- the company should be put into liquidation (see paragraph 3.8).
- the company should be returned to the control of the directors (this is very rare).

The requisite majority is a majority in number and 75% in value of those voting.

3.7 The courts are involved in the following situations: the administrator or a creditor can apply to the court for a wide range of supervisory orders and any creditor prejudiced by the administration or who may be prejudiced by the deed of company arrangement can apply to the court for relief or for termination of the deed.

Liquidation of the company

3.8 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 liquidation.

Receivership

3.9 Secured creditors stand outside liquidation, and often stand outside formal creditors compromises. The right of secured creditors to realise their security is not affected by a creditors compromise or deed of company arrangement (unless they agree, or in the case of a deed of company arrangement, the court orders otherwise) 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 or an administrator under the voluntary administration regime (see paragraph 3.5 above). With certain statutory exceptions, the secured creditor has first rights over the secured assets until its debt is paid in full.

3.10 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

3.11 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.

3.12 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.

3.13 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).

3.14 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.

3.15 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 As a result of a change in late 2007 to the procedure for setting aside insolvent transactions and voidable charges (the onus is now on the liquidator to commence proceedings to set aside a transaction if a creditor has objected to a setting aside notice – previously the creditor had to apply to court for an order that the transaction should not be set aside), it is thought that there will be fewer court applications. This is primarily because of current uncertainty as to whether, if a liquidator's application to set aside is unsuccessful, the court will order costs against the liquidator who may not have funds in the liquidation to meet that order.

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.

POLAND

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 According to the Polish Bankruptcy and Reorganisation Law of 28 February 2003, as amended (BARL), in the context of commencement of the "twilight" period, the crucial date is the day the bankruptcy petition is presented in the court, as the subject period is measured back from this moment.

1.1.2 The bankruptcy is declared in relation to a debtor who has become insolvent. The debtor is deemed insolvent if the debtor fails to perform its due pecuniary liabilities. In addition, a corporate debtor is deemed insolvent when the sum of its liabilities exceeds the value of its assets, even though the debtor duly performs those liabilities. For a more general description of Polish bankruptcy law, please see the appendix to this analysis.

1.1.3 Under BARL, in order to be eligible for bankruptcy, one has to be a professional entrepreneur, defined as a natural person, legal person or unincorporated business entity granted legal capability by a separate law, conducting business or professional activity in its own name.

The scope of this chapter is limited to commercial companies with limited liability (*spółka z ograniczoną odpowiedzialnością*) and joint stock companies (*Spółka Akcyjna*).

The word "company" shall hereinafter be used interchangeably with the words "bankrupt" and "debtor".

Polish law follows European continental law in terms of the corporate bodies of commercial companies. The corporate bodies of Polish commercial companies (both limited liability and joint stock) are:

- shareholders' meeting (*zgromadzenie wspólników or walne zgromadzenie*);
- management board (*zarząd*);
- supervisory board (*rada nadzorcza*); and
- audit committee (*komisja rewizyjna*).

The function of an executive director – a person who manages the affairs of the company and represents the company is, in Polish companies, referred to as the function of the member of the management board. Therefore, the word "director" shall hereinafter mean and be used as an equivalent to member of the management board. BARL also uses the term "debtor's representative" – pursuant to the common interpretation of this term and, in the context of BARL, it should be interpreted as meaning a member of the management board.

In addition to the management board, Polish law recognises the function of a commercial proxy (commercial plenipotentiary, *prokura*), a type of commercial unlimited power of attorney given by the entrepreneur registered with the entrepreneurial register, which encompasses an authorisation to perform in-court and out-of-court acts connected with carrying on business activity. In practice it is quite common for Polish companies to appoint proxies having the right to represent the company, usually jointly with one of the directors of the company.

1.2 The “twilight” period in Polish law

Under Polish law, the BARL and the Civil Code of 23 April 1964, as amended (CC), the “twilight” period may be defined as the period, preceding presentation of the bankruptcy petition in court, during which transactions entered into by a company are or may be held ineffective (*bezskuteczne*) in relation to the bankruptcy estate. In such circumstances, ineffective (*bezskuteczność wzgledna*) means that the transaction remains valid and produces desired legal effects but is ineffective in relation to certain person or persons. However, as BARL provides for ineffectiveness in relation to the bankruptcy estate, such transactions in practical terms are ineffective in relation to all the bankrupt’s creditors.

Transactions determined in BARL’s articles 127 and 128 (refer to 1-6 in the table below) are ineffective *ex lege*. On the other hand, transactions determined in BARL’s articles 129 and 130 and CC’s Book III Title X require a court decision to be deemed ineffective.The length of the “twilight” period varies, depending on the nature of the transaction entered into by a company. BARL provides for several types of transactions which, if performed during the “twilight period”, are or may be held to be ineffective. The table below shows the types of such transactions and length of the “twilight” period.

Acts which may give rise to personal – either criminal or civil – liability on part of directors do not have to occur within the “twilight” period in order for liability to attach.

No.	Nature of the transaction	Length of the twilight period	Legal basis
1*	Disposal of assets in exchange for no consideration or if the value of the bankrupt’s performance significantly exceeds the value of consideration received by the bankrupt or reserved for the bankrupt or for a third party	one year	BARL’s Art. 127 par. 1
2.*	In-court settlement, acknowledgement and waiver of claim in circumstances described in 1 above	one year	BARL’s Art. 127 par. 2
3.*	Securing and paying undue debt, unless the party which received payment or was granted security was unaware of the existence of the basis for declaring bankruptcy	two months	BARL’s Art. 127 par. 3
4.	Transactions with bankrupt’s partners, shareholders, representatives or their spouses	six months	BARL’s Art. 128 par. 2
5.	Transactions with bankrupt’s affiliates, their shareholders, representatives or their spouses	six months	BARL’s Art. 128 par. 2
6.	Transactions between the bankrupt and other company if one of them is a dominant company	six months	BARL’s Art. 128 par. 3
7.**	Remuneration of a bankrupt’s representative significantly exceeding the average amount of such remuneration while not justified by the work input	prior to bankruptcy declaration, but for a period no longer than six months prior to presentation of bankruptcy petition ***	BARL’s Art. 129 par. 1 BARL’s Art. 129 par. 1
8.**	Compensation payable in connection with the termination of employment or a service contract, related to the management of the bankrupt’s enterprise in circumstances described in 7 above	prior to bankruptcy declaration, but for a period no longer than six months prior to presentation of bankruptcy petition ***	BARL’s Art. 129 par. 3
9.**	Granting a mortgage, pledge, registered pledge or maritime mortgage over a bankrupt’s assets when the bankrupt is not a personal debtor of the secured creditor and the bankrupt received no consideration for the grant of such security or if the value of such consideration was disproportionately lower than the value of the security granted	one year	BARL’s Art. 130 par. 1 and 2
10.**	Granting an encumbrance to secure the debts of persons described in points 4, 5 and 6 above	one year	BARL’s Art. 130 par. 3
11	*Actio pauliana* (for details please see 4.3.4 below)	unlimited	CC’s Book III Title X

* Inapplicable in relation to securities established prior to the declaration of bankruptcy in connection with futures or securities buy-back transactions or transactions the subject of which is a loan of securities.

** May be held ineffective by the bankruptcy judge; for details please see 4.3 below.

*** In addition, remuneration of debtor’s representative in respect of the period following the bankruptcy declaration may be held ineffective by the bankruptcy judge if, in view of the work input of the trustee or administrator, the amount of such remuneration is not justified. The same rule applies to the compensation payable in connection with the termination of an employment or a service contract, related to the management of the bankrupt’s enterprise.

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 General overview

The Polish law does not directly impose sanctions – either civil or criminal – on members of corporate bodies for entering into transactions specifically during the “twilight” period. Instead, members of corporate bodies may – in accordance with the acts of general applicability, for instance Criminal Code or CC, but also BARL – be held liable for breach of their duties connected with their function within bankruptcy proceedings, for putting the company or its creditors at risk of incurring losses or for actually making the company or its creditors incur losses.

2.2 Bankruptcy and Reorganisation Law (BARL)

2.2.1 Article 373 paragraph 1 point 1 and article 374 paragraph 1 specify the following breaches of duty:

(a) Failure to present a bankruptcy petition in court within two weeks from the moment when the basis for bankruptcy declaration commenced (article 373 paragraph 1 point 1) and causing, by wilful misconduct or gross negligence, insolvency of the company (article 374 paragraph 1).

(b) (i) In such circumstances the liability is theoretically civil (it is imposed by civil courts according to the rules of civil procedure), but in practical terms, it is quasi criminal.

(ii) Liability takes the form of a prohibition – three to ten years in duration – on conducting business activities on the person’s own account or as a member of the supervisory board, representative or attorney-in-fact of a commercial company, state-owned enterprise, co-operative, foundation or association (*stowarzyszenie*).

(iii) When imposing the period of the prohibition, the court should consider the degree of fault and result of the acts undertaken, including in particular the decrease in the economic value of the bankrupt’s enterprise and the extent of creditors’ damages. The court may also refrain from imposing a prohibition if the petition for bankruptcy declaration was rejected in certain circumstances (delay in performance of obligations by the debtor does not exceed three months and the total amount of unperformed obligations does not exceed 10% of value of debtor’s enterprise) and the court has permitted the commencement of the reorganisation procedure for the debtor.

(iv) As mentioned above – under BARL’s article 373 paragraph 1 point 1 – liability attaches, subject to other provisions of BARL, if the bankruptcy petition was not presented in court within two weeks from the moment when the grounds for bankruptcy declaration started to exist.

There is no specified timeframe during which an act – described in BARL’s article 374 paragraph 1 – (causing the insolvency of the company) must have been undertaken for liability to attach.

(v) Defences are:

- the degree of fault was low enough not to justify imposing the prohibition, or imposing the prohibition of minimum length (three years); and/or
- the result of the failure to present a bankruptcy petition does not justify the imposition of the penalty (for instance, no creditor suffered damages as a result).

2.2.2 BARL’s Article 21

(a) Failure to present a bankruptcy petition in court within two weeks from the moment when the grounds for bankruptcy declaration started to exist.

(b) (i) Liability is civil.

(ii) A director can be made personally liable in respect of the whole loss caused to the company and to the company’s creditors.

(iii) In the event the failure to present a bankruptcy petition is a result of negligence of more than one person, liability is joint and several.

(iv) Please see 2.2.1(b)(iv) above in relation to BARL's article 373 paragraph 1 point 1.

(v) Please see 2.5.1(b)(v) below.

2.3 Criminal Code

There are several types of crimes which under the Polish Criminal Code of 6 June 1997 (CrimC) may be qualified as relating to duties of members of corporate bodies regarding the twilight zone.

Under article 308 of the CrimC, liability for the crimes below falls on the person who (on the basis of law, decision of the relevant authority, agreement or as a matter of fact) manages the financial matters of another legal person, natural person, group of persons or an entity without legal personality.

2.3.1 Article 300 paragraph 1

(a) Causing (by means of removal, concealment, disposal, gift, destruction, establishment of actual or apparent encumbrance or causing damage to the company's assets) a frustration or limitation to the extent a company's creditor may satisfy its claims against the company, in the event the company is insolvent or is in danger of insolvency.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to imprisonment for up to three years. If as a result of the act many creditors of the company suffer damages, the penalty is imprisonment for up to eight years.

(iii) General terms of Polish criminal law govern the extent of the penalty imposed. Sentencing is for the court's discretion but the court is required to take into account the degree of fault, social harmfulness and a consideration of preventive and educational purposes of the penalty in relation to the perpetrator and also the desire to create legal awareness in society.

Also, when imposing a penalty, the court takes into account among other things the motivation and behaviour of the perpetrator, the nature and degree of infringement of the perpetrator's duties, personal features of the perpetrator and his or her behaviour after committing the crime (especially attempts to repay damages) and the behaviour of the aggrieved party.

(iv) CrimC provides no specified period before the 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) According to article 307, in the event the perpetrator has voluntarily covered all the damages, the court may extraordinarily commute a sentence or even not impose a penalty at all.

In the event the perpetrator has voluntarily covered a substantial part of the damages, the court may extraordinarily commute a sentence.

2.3.1.1 It is important to note that the general terms stated in 2.3.1(b) apply to articles 296 and 300-303.

2.3.2 Article 300 paragraph 2

(a) Causing (by means of removal, concealment, disposal, gratuitous disposal, destruction, establishment of actual or apparent encumbrance or causing damage to the company's assets levied or at risk of levy or by means of removal of official marks of levy) a frustration or limitation to the extent that a company's creditor may satisfy its claims against the company for the purpose of causing a frustration of execution of the decision of the court or other state organ.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to imprisonment for up to five years.

2.3.3 Article 301 paragraph 1 and 2

(a) Causing (by establishing in accordance with law a new business entity and transferring to it the company's property) a frustration or limitation of the extent that several of the company's creditors may satisfy their claims against the company.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to imprisonment for up to five years. The penalty is the same if the company caused several of its creditors to become bankrupt or insolvent.

2.3.4 Article 301 paragraph 3

(a) Recklessly causing the company's bankruptcy or insolvency (in particular by wasting components of the company's property, incurring liabilities or making transactions obviously in contradiction with principles of good management) while the company is in debt to several creditors.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to fine, restriction of freedom or imprisonment for up to two years.

2.3.5 Article 302 paragraph 1

(a) Performing or securing obligations in relation to only some of the company's creditors thus acting to the detriment of the remaining creditors while the company is in danger of insolvency or bankruptcy and is unable to satisfy its liabilities to all of its creditors.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to fine, restriction of freedom or imprisonment for up to two years.

2.3.6 Article 302 paragraph 2

(a) Delivering or promising to deliver a material benefit to a creditor of the company in consideration for acting to the detriment of other creditors in the context of bankruptcy proceedings or proceedings which have as their purpose the prevention of bankruptcy.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to imprisonment for up to three years.

2.3.7 Article 303

(a) Causing (by not keeping books of business activity or keeping the books negligently or inaccurately, especially by destroying, removing, concealing or forging such books) a natural person, legal person or an entity with no legal personality to suffer material damages.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to imprisonment for up to three years.

If the amount of damages exceeds PLN 200,000 (thus constituting damages in a substantial amount), a person guilty of this misdemeanour is liable to imprisonment for up to five years.

2.3.8 Article 296

(a) Causing (by abuse of power or failure to satisfy relevant obligations) a company to suffer damages in a substantial amount, while being obliged, pursuant to any law, decision of a relevant organ or an agreement, to manage the financial affairs or business activities of such company.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to imprisonment for up to five years.

If a perpetrator, by abuse of power or failure to satisfy relevant obligations, brings upon a company a direct threat of suffering damages of a substantial amount, they are liable to imprisonment for up to three years.

If a perpetrator acted for the purpose of gaining a material benefit, they are liable to imprisonment for up to eight years.

If the amount of damages exceeds PLN 1,000,000, a person guilty of this misdemeanour is liable to imprisonment for up to ten years.

If the perpetrator acted unintentionally, they are liable to imprisonment for up to three years.

2.4 Commercial Companies Code

The Commercial Companies Code of 15 September 2000, as amended (CompC), provides two regimes governing the liability of members of corporate bodies – one relating to limited liability companies (*spółka z ograniczoną odpowiedzialnością*) and the other relating to joint stock companies (*Spółka Akcyjna*). There are also provisions of a criminal nature relating to both types of companies.

2.4.1 Provisions relating to limited liability companies

2.4.1.1 Article 293

(a) Causing damages by an act or omission contrary to the law or the company's agreement, by members of the management board, supervisory board, audit committee or liquidator, unless there was no fault.

(b) (i) Liability is civil.

(ii) A person is liable in respect of the whole loss caused to the company.

(iii) The liability of the persons listed in CompC's article 293 is joint and several.

(iv) There is no specified period before the commencement of a subsequent insolvency procedure during which this act must have been undertaken in order for liability to attach to a director. However, the statute of limitations for bringing such a claim runs for three years from the day when the company became aware of the occurrence of the damage and of a person liable to redress it. In either case the statute of limitations lapses after ten years from the day when the damage occurred.

(v) In order to avoid liability, a person must prove that there was no fault on their part.

Under CompC's article 296, it is not a defence that the persons liable for damages have been discharged by a resolution of the shareholders' meeting or a waiver of rights by the company if the company is bankrupt or if the action for damages was brought by one of the company's shareholders.

2.4.1.2 Article 299

(a) Procuring a situation when execution against the company proves to be ineffective.

(b) (i) Liability is civil.

(ii) Members of the management board are liable for all the obligations of the company.

(iii) The liability of the members of the management board is joint and several.

(iv) Please see point (v) below.

(v) A member of the management board may release himself from the liability if he proves that:

- the bankruptcy motion was presented and the reorganisation proceedings were commenced in the appropriate time;

- the failure to present the bankruptcy motion or the failure to commence the reorganisation proceedings were not his fault; and

- although the bankruptcy motion was not presented or the reorganisation proceedings were not commenced, the creditor of the company suffered no damages.

Under CompC's article 296, it is not a defence that the persons liable for damages have been discharged by a resolution of the shareholders' meeting or a waiver of rights by the company if the company is bankrupt or if the action for damages was brought by one of the company's shareholders.

2.4.2 Provisions relating to joint stock companies – CompC's article 483

(a) Causing damages by an act or omission contrary to the law or the company's articles of association, by members of the management board, supervisory board, review board or liquidator, unless there was no fault.

(b) (i) Liability is civil.

(ii) A person is liable in respect of the whole loss caused to the company.

(iii) The liability of the persons listed in CompC's article 483 is joint and several.

(iv) There is no specified period before the commencement of a subsequent insolvency procedure during which this act must have been undertaken in order for liability to attach to a director. However, the statute of limitations for bringing such a claim runs for three years from the day when the company became aware of the occurrence of the damage and of a person liable to redress it. In either case the statute of limitations lapses after five years from the day when the damage occurred.

In order to avoid liability, a person must prove that there was no fault on his part.

Under CompC's article 487, it is not a defence that the persons liable for damages have been discharged by a resolution of the shareholders' meeting or a waiver of rights by the company if the company is bankrupt or if the action for damages was brought by one of the company's shareholders or by another person possessing a different participation interest in the profit or the distribution of the company's assets.

2.4.3 Article 586

(a) Failure to present a bankruptcy petition by a member of the management board or the liquidator of the company, despite the existence of the grounds for a bankruptcy declaration.

(b) (i) Liability is criminal.

(ii) A person guilty of this misdemeanour is liable to fine, restriction of freedom or imprisonment for up to one year.

(iii) Please see 2.3.1(b)(iii) above.

(iv) CompC provides no specified period before the commencement of a subsequent insolvency procedure during which the relevant act must have been undertaken in order for liability to attach to a director.

(v) There are no special defences available in respect of this misdemeanour under CompC; only general provisions of the Polish criminal law apply.

2.5 Tax Ordinance Act

The Tax Ordinance Act of 29 August 1997, as amended (TOA), is an Act regulating, among other things, tax obligations. At several instances the TOA refers to insolvency procedure and proceedings. The scope of this chapter only considers the TOA's article 116 addressed below. This article regulates the administrative liability of a director for outstanding tax payments of the company or a company in the process of being formed (i.e. not yet registered in the entrepreneurial register) in the event that the execution of tax payments against the property of the company prove to be entirely or partly ineffective.

(a) (1) Failure to prove that:

(a) the bankruptcy petition was presented with the court or a reorganisation proceeding was commenced in the applicable time; or

(b) the failure to present a bankruptcy petition or failure to commence reorganisation proceedings was not the fault of the director.

(2) Failure to indicate the company's property, which could serve to satisfy outstanding tax payments of the company to a material degree, if execution of tax payments against property of the company prove to be entirely or partly ineffective.

(b) (i) Liability is administrative. This is a special kind of liability, enforceable by public administrative authorities, through the issuance of administrative decisions.

(ii) The director can be made personally liable for the payment of the outstanding tax payments, the payment term of which has expired and, in relation to certain public obligations, which arose while a person was performing the duties of director, irrespective of whether a person still holds a directorial position.

(iii) The liability of the directors is joint and several. Also, the directors are jointly and severally liable with the company.

(iv) There is a specified period in relation to acts described in point (a)(1) above. The period is two weeks from the moment when grounds for bankruptcy declaration started to exist.

(v) The defences are, contrary to the wording of TOA's article 116:

- proving that the bankruptcy petition was presented or reorganisation proceedings were commenced in the applicable time;
- proving that the failure to present the bankruptcy petition or the failure to commence reorganisation proceedings was not a fault of the director;
- indicating the company's property, which could serve to satisfy outstanding tax payments of the company to a material degree;
- proving that the payment term of outstanding tax payments had expired and, in relation to certain public obligations, that those obligations arose while a person was not performing the duties of director;
- proving that the execution of tax payments against property of the company has been entirely effective.

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 overview

Certain persons other than directors can be held liable like directors. The nature and character of the function of the person who may be held liable as if a director depends on the nature of transaction or act undertaken by such person, which are listed in question 2 above.

3.2 Liability under BARL

(a) Under BARL's article 373 paragraph 1 point 1 and article 374, the persons who may be held liable are all persons who, while obliged by law to present a bankruptcy petition within two weeks from the moment when the grounds for bankruptcy declaration started to exist, did not do so (that is, persons authorised to represent the company solely or jointly with other persons). Therefore, persons other than directors, liable under BARL's provisions as indicated in question 2 above, are liquidators. According to the prevailing opinion of BARL commentaries, proxies (*prokurenci*) cannot be held liable under article 373 paragraph 1 point 1 and 374 because their duties do not include handling a company's matters and they do not have access to a relevant company's books, records and information.

(b) Liquidators may be held liable for the same acts as directors and to the same extent.

(c) The extent of the liability of persons other than directors is the same as that for directors.

3.3 Liability under the Criminal Code (CrimC)

(a) The crimes listed in 2.3 above are stated chapter XXXVI Crimes against the market. Article 308 provides that, for crimes committed under this chapter, a debtor is liable like any person who on the basis of committed legal provision, decision of relevant authority, contract or by actual performance handles matters of the company's property.

(b) Persons other than directors may be held liable for the same acts as directors and to the same extent.

(c) The extent of the liability of persons other than directors is the same as that of directors.

3.4 Civil liability under the Company Code (CompC)

(a) As noted above, under this code articles 293 and 483, those who are liable as directors are the members of the company's supervisory board, audit committee and a liquidator. According to article 299 only directors are liable.

(b) Persons other than directors may be held liable for the same acts as directors and to the same extent.

(c) The extent of the liability of persons other than directors is the same as that of directors.

3.5 Criminal liability under the Company Code (CompC)

(a) Under CompC's article 586, only liquidators are liable alongside directors.

(b) Persons other than directors may be held liable for the same acts as directors and to the same extent.

(c) The extent of the liability of persons other than directors is the same as that of directors.

3.6 Liability under Tax Ordinance Act (TOA)

(a) According to TOA's article 116 those liable as directors are, in the event the company is in the process of being formed and does not yet have directors, the company's attorney-in-fact or the shareholders, if the attorney-in-fact is not appointed.

(b) Persons other than directors may be held liable for the same acts as directors and to the same extent.

(c) The extent of the liability of persons other than directors is the same as that of directors.

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 Summary

As noted in question 1 above, transactions entered into by the company during the "twilight" period are either (i) ineffective ex lege and thus any possible court order only "confirms" that such transactions are ineffective, or (ii) may be held ineffective by the court.

4.2 Ineffective transactions

Transactions that can be made ineffective *ex lege* are:

(a) where the company disposes of its property at an undervalue (including in-court settlements and acknowledgements and waivers of claims against);

(b) securing and paying non-payable debts;

(c) with persons and entities having an interest in the company, power over the company or being tied financially with the company.

4.2.1 *Disposal of the property under value*

Under BARL's article 127 paragraphs 1 and 2, such transactions are ineffective if the following conditions are met:

(a) the transaction or the in-court settlement, acknowledgement or waiver of claims took place during the year preceding the presentation of the bankruptcy petition with the court; and

(b) on the basis of the acts described in (a) above, the company disposed of its property for no consideration or the value of the company's performance grossly exceeded the value of performance received by the company or reserved for the company or for a third party.

There will be a lack of consideration if the company (or a third party designated by the company) receives, or is to receive, no material benefit in exchange for its own performance, for instance if the company makes a gift. Whether there was a gross disproportion between the value of the company's performance and consideration received is to be measured on the basis of average prices, rates, etc. commonly used in business in the same or similar transactions.

4.2.2 *Securing and paying non-payable debts*

Under BARL's article 127 paragraphs 3, such transactions are ineffective if the following conditions are met:

(a) the transaction took place during the two months preceding the presentation of the bankruptcy petition with the court; and

(b) the transaction related to non-payable debts at the time of the payment or the grant of security.

However, the transaction is not ineffective if the creditor, at the time of the payment or the grant of security by the company, was unaware that the grounds for declaring bankruptcy of the company existed.

4.2.3 *Transactions with specially designated persons*

Under BARL's article 128 paragraphs 2 and 3, such transactions are ineffective if the following conditions are met:

(a) the transaction took place during the six months preceding the presentation of the bankruptcy petition with the court;

(b) the transaction was a payable transaction; and

(c) the transaction was between the company and:

  (i) the company's shareholders;

  (ii) the company's shareholders' representatives or spouses;

  (iii) the company's affiliates, their shareholders, representatives or spouses of those persons; or

  (iv) other companies, if one of those companies was a dominant company.

The transaction is a payable transaction if a performing party receives or is to receive in exchange a material benefit. The company's representatives are members of the company's management bodies.

An affiliated company is a capital company in which another commercial company or a co-operative controls, directly or indirectly, at least 20% of the votes at the shareholders' meeting, also as pledge or usufructuary, or under agreements with other parties, or which directly holds at least 20% of the shares in another capital company (CompC's article 4 paragraph 1 point 5).

A dominant company is a commercial company if:

(a) it controls, directly or indirectly, a majority of the votes at the shareholders' meeting, also as pledge or usufructuary, or in the management board of another capital company (a dependent company), also under agreements with other parties; or

(b) it is entitled to appoint or dismiss a majority of the members of the management board of another capital company (a dependent company) or a co-operative (a dependent co-operative), also under agreements with other parties; or

(c) it is entitled to appoint or dismiss a majority of the members of the supervisory board of another capital company (a dependent company) or a co-operative (a dependent co-operative) also under agreements with other parties; or

(d) more than half of the members of the management board of the capital company are also members of the management board of the dependent company or the dependent cooperative; or

(e) it controls, directly or indirectly, a majority of the votes in the dependent partnership or at the shareholders' meeting of the dependent cooperative, also under agreements with other parties; or

(f) it exerts a decisive influence on the operations of the dependent capital company or the dependent cooperative (CompC's article 5 paragraph 1 point 4).

4.3 Heads of challenge

The potential heads of challenge which may lead to transactions being held ineffective, pursuant to relevant BARL's and CC's provisions listed in the table in question 1 above, relate to transactions:

(a) regarding labour related payments for representatives of the company or persons managing the business enterprise of the company;

(b) encumbering the company's property when the company is not a personal debtor of the secured creditor and receives no consideration for such encumbrance or the encumbrance was granted in exchange for consideration of a significantly lower value than the value of the encumbrance granted;

(c) encumbering the company's property to secure debts of persons and entities having an interest in the company, power over the company or tied financially with the company;

(d) being detrimental to the company's creditors.

4.3.1 *Labour related payments*

Under BARL's article 129 paragraphs 1 and 3 such payments may be held ineffective in relation to the bankruptcy estate if the following conditions are met:

(a) a labour agreement or agreement for rendition of services was entered into before the bankruptcy declaration;

(b) such agreement was entered into by the company and a representative of the company; and

(c) remuneration:

  (i) was grossly excessive in comparison to average remuneration for the same type of work or services; and

  (ii) was not substantiated by the amount of work; or

(d) benefit paid to the person managing the enterprise of the company for termination of the agreement with such person was grossly excessive in comparison to average benefits for the same type of work or services.

The bankruptcy judge, on the motion of the trustee, court supervisor or administrator or ex officio may hold the specific part of remuneration ineffective in relation to the bankruptcy estate. The bankruptcy judge specifies the remuneration which is to be satisfied from the bankruptcy estate in an amount corresponding to the work or services performed by the representative of the company or, in case of benefits for termination of the agreement, with the person managing the enterprise of the company, in an amount determined under the generally applicable rules.

The excessiveness of the remuneration or benefit must be gross and is measured according to average contractual rates used in the market, after taking into consideration the size, industry and location of enterprise.

4.3.2 *Encumbrance of the company's property – the company was not a personal debtor*

Under BARL's article 130 paragraphs 1 and 2, encumbrance of the company's property in such circumstances may be held ineffective in relation to the bankruptcy estate if the following conditions are met:

(a) the company's property was encumbered during the year preceding presentation of the bankruptcy petition with the court;

(b) the encumbrance established on the company's property was a:

(i) mortgage;

(ii) pledge;

(iii) registered pledge; or

(iv) maritime mortgage;

(c) the company was not a personal debtor of the secured creditor;

(d) the company received no consideration for the grant of such security; or

(e) the encumbrance was granted in exchange for a consideration of a significantly lower value than the value of such encumbrance.

The bankruptcy judge, on the motion of the trustee, court supervisor or administrator may hold that the encumbrance is ineffective in relation to the bankruptcy estate.

It is irrelevant whether the debt secured this way was payable.

4.3.3 *Encumbrance of the company's property – debts of specially designated persons*

Under BARL's article 130 paragraph 3, encumbrancing the company's property may be held ineffective in relation to the bankruptcy estate if the following conditions are met:

(a) the company's property was encumbered during the year preceding presentation of the bankruptcy petition with the court;

(b) the encumbrance established on the company's property was a:

(i) mortgage;

(ii) pledge;

(iii) registered pledge; or

(iv) maritime mortgage;

(c) the company was not a personal debtor of the secured creditor; and

(d) the encumbrance secures debts of:

(i) the company's shareholders;

(ii) the company's shareholders' representatives or spouses;

(iii) the company's affiliates, their shareholders, representatives or spouses of those persons; or

(iv) other company, if that company was a dominant company.

The bankruptcy judge may hold as ineffective any encumbrance granted to secure the debts of the persons specified above irrespective of the value of the consideration received by the company for granting such an encumbrance.

4.3.4 *Transactions detrimental to the company's creditors*

BARL's article 131 provides that in all matters not regulated in articles 127- 130, articles 132-134 and the CC's provisions regarding protection of creditors in the event of a debtor's insolvency, apply accordingly to actions brought against transactions of the bankrupt detrimental to creditors. The relevant CC provisions constituting *lex specialis* to BARL (governing the so called *actio pauliana*) are discussed below.

4.3.4.1 *Actio pauliana – general overview*

In addition to the transactions described above, Polish law recognises the legal principle known as *actio pauliana*. This principle is regulated by Title X of the CC: "Protection of creditors in the event of the debtor's insolvency".

The CC provides that if, as a result of a transaction made by the debtor to the detriment of creditors, a third party gains a material benefit, each creditor affected may demand that the transaction be held ineffective with respect to him if the debtor acted deliberately to the detriment of creditors and the third party was aware of this or, acting with due care, could have become aware.

4.3.4.2 Required elements

Under CC's article 527, in order to hold a transaction ineffective in relation to a creditor, the following conditions have to be met:

(a) a debt has to exist;

(b) a transaction has to be entered into with a third party;

(c) the transaction must be detrimental to creditors;

(d) a third party gains a material benefit;

(e) the debtor acts deliberately to the detriment of creditors;

(f) the third party acts in bad faith.

In the event all of the above conditions are met, transactions entered into by the debtor may be held ineffective in relation to the creditor (relative ineffectiveness) in an action brought against the third party with whom the debtor entered into the transaction or by bringing a charge *(zarzut)* against the third party (CC's article 531 paragraph 1). If the third party has disposed of the material benefit, the creditor may bring an action directly against the person to whom the benefit of the disposition was made as long as that person was aware of the circumstances based on which the effectiveness of the transaction is being challenged or if the disposition was gratuitous (CC's article 531 paragraph 2).

4.3.4.3 Statutory presumptions

In the context of *actio pauliana* it is presumed that:

(1) the transaction was to the detriment of creditors if (as a result of that transaction) the debtor became insolvent or became insolvent to a greater degree than before entering into the transaction (CC's article 527 paragraph 2).

(2) if, as a result of the transaction entered into by the debtor to the detriment of creditors, a material benefit was gained by a person who was in a close relationship or a permanent economic relationship with the debtor, such person was aware that the debtor acted deliberately to the detriment of creditors (CC's article 527 paragraph 3). Note that the range of such persons is broader than persons described in BARL's article 128.

(3) if, as a result of the transaction entered into by the debtor to detriment of creditors, a third party gained a material benefit gratuitously, each creditor may demand that the transaction be held ineffective even if that third party was not aware or, acting with due care, could not have become aware that the debtor acted deliberately to the detriment of creditors (CC's article 528). Note that under this provision the fact that the third party acted in good faith is irrelevant.

(4) if at the time of a donation the debtor was insolvent, it shall be presumed that he acted deliberately to the detriment of creditors. The same applies if the debtor became insolvent as a result of making the donation (CC's article 529).

(5) the preceding provisions apply correspondingly where the debtor acted intentionally to the detriment of future creditors. But if a third party gained a material benefit for good consideration, the creditor may demand that the act be declared ineffective only if the third party knew of the intention of the debtor (CC's article 530).

QUESTION 5

5. Enforcement

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

5.1 General overview

Legal eligibility to bring or commence legal proceedings against directors and other persons identified above depends on whether the action is civil, criminal or administrative in nature.

5.2 Civil proceedings

Activity	Persons eligible to bring or commence legal proceedings
BARL's Art. 373 par. 1 pt. 1 and BARL's Art. 374 par. 2	Creditor, interim court supervisor (*tymczasowy nadzorca sądowy* – who may be appointed by the court after the presentation of a bankruptcy petition in order to secure the debtor's assets), compulsory administrator (*zarządca przymusowy* – who may be appointed by the court after the presentation of a bankruptcy petition in order to secure the debtor's assets), trustee, court supervisor or administrator, the President of the Office for Competition and Consumer Protection (*Prezes Urzędu Ochrony Konkurencji I Konsumentów*) and the Chairman of the Securities and Exchange Commission (*Przewodniczący Komisji Nadzoru Finansowego*).
BARL's Art. 21	Any person or entity which has suffered a loss as a result of an activity.
CompC's Art. 293	The company or each shareholder of the company – if the company does not bring an action within one year from the day on which the act resulting in damage was disclosed.
CompC's Art. 299	Any creditor of the company.
CompC's Art. 483	The company or each shareholder or person having a different participation interest in profit or distribution of the assets of the company – if the company does not bring an action within one year from the day on which the act resulting in damage was disclosed.

5.3 Criminal proceedings

As a general rule, criminal proceedings in Poland are commenced and carried on ex officio by the specialised public authorities, especially the police and prosecutor's office. There are two exceptions to this general rule, which are specifically determined in criminal law provisions. One exception is that criminal proceedings relating to some crimes may be commenced only on the motion of the aggrieved party (in this event, however, the proceedings are carried on ex officio as well – only the motion to commence them is needed).

Additionally, every person or entity may submit to any public organ (usually specialised in prosecuting crimes) a notification regarding suspicion of a crime committed. In this way, the public organ is informed that a crime might have been committed and, after verification of the notification and circumstances around it, may commence proceedings.

Activity	Persons eligible to bring or commence legal proceedings
CrimC's Art. 300 par. 1	Ex officio, if the aggrieved party is State Treasury; otherwise the proceedings are commenced at the motion of the aggrieved party
CrimC's Art. 300 par. 2	Ex officio
CrimC's Art. 301 par. 1 and 2	Ex officio
CrimC's Art. 301 par. 3	Ex officio
CrimC's Art. 302 par. 1	Ex officio
CrimC's Art. 302 par. 2	Ex officio
CrimC's Art. 303	Ex officio, if the aggrieved party is State Treasury; otherwise the proceedings are commenced at the motion of the aggrieved party
CompC's Art. 586	Ex officio
CrimC's Art. 296	Ex officio; in relation to a crime of bringing upon a company a direct threat of suffering damages in a substantial amount – the proceedings are commenced at the motion of the aggrieved party, unless the aggrieved party is State Treasury

5.4 Administrative proceedings under TOA's article 116

This type of proceeding may be commenced by any tax organ with relevant jurisdiction, based on the company's registered seat. According to TOA's article 13, the relevant tax organ is (in the context of this analysis):

(1) the chief officer (*naczelnik*) of the tax office, customs office, voit (*wójt*), mayor (president of municipality), *starost*, marshal of the *voivodship* – as the organ of first instance;

(2) the director of the tax chamber, director of the customs chamber – as:

  (a) the appellate organ for decisions of the chief officer of the tax office or customs office respectively;

  (b) the organ of first instance, in situations provided by separate rulings;

  (c) the appellate organ for decisions issued by this organ in the first instance;

(3) the self-governmental committee of appeals (*samorządowe kolegium odwoławcze*) – as the appellate organ for decisions of voit, mayor (president of municipality), *starost* or marshal of the *voivodship*.

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**
All offences referred to in 2 above, resulting in criminal liability	In addition to the penalties mentioned in 2 above in respect of offences resulting in criminal liability, Polish criminal law also allows the courts to impose several penal measures, remedial in nature. In this context, these penal measures (provided for by Article 39), include: (1) prohibition on serving a specific function, practice specific professions or carrying a specific business activity for a period of between one and ten years; (2) confiscation of property; (3) an obligation to redress damages or compensate for emotional distress; (4) an award of compensatory damages to the aggrieved party (nawi zka) in the amount of up to PLN 100,000; (5) an award of cash payment to a specifically designated fund (*świadczenie pieniężne*) in the amount of up to PLN 60,000; (6) making the sentence publicly known.
All offences referred to in 2 above, resulting in civil liability (except BARL's Art. 373 and 374)	Duty to redress the damages caused.
BARL's Art. 373 and 374	Please see question 2 above.
BARL's Art. 127-130	Under BARL's Art. 134, in the event an act of the company is ineffective *ex lege* or is held to be ineffective by the court, an order that everything which as a result of the act has been transferred out of the company's estate must be returned to the bankruptcy estate; in the event an in-kind transfer is not possible, the cash equivalent shall be paid to the bankruptcy estate. In such event, the reciprocal performance of a third party is returned if it is included in the bankruptcy estate separately from other assets or if the bankruptcy estate is enriched as a result. In the event the performance cannot be returned, a third party may pursue its claim in the bankruptcy proceedings.
Actio pauliana	Under CC's Art. 532 the creditor in respect of whom the company's transaction was held ineffective may, with priority over the creditors of the third party, vindicate the rights in the assets which, as a result of the transaction were held ineffective, left the estate of the company or did not enter it. Under CC's Art. 533 the third party who gained a material benefit as a result of a transaction entered into to the detriment of the creditors may release itself from the duty to satisfy the claim of the creditor requesting that the transaction be held ineffective, if it satisfies that creditor or indicates to the creditor that the company has sufficient property to satisfy the creditor's claim.
TOA's article 116	Duty to repay outstanding tax obligations.

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 Obligations under BARL's article 57

Under BARL's article 57, in the event a bankruptcy by liquidation of the company's assets has been declared (or if bankruptcy with the possibility of making a composition arrangement has been declared but the company has been deprived of the right to administer its assets), the company is required to indicate (through bodies authorised to represent the company) and release all of its assets to the trustee, as well as surrendering all documents related to its activities, assets and accounts, including the book accounts, other records maintained for tax purposes and correspondence. The company is required to confirm performance of this obligation by submitting a written declaration to the bankruptcy judge.

The company is also mandated to provide the bankruptcy judge and trustee with all necessary explanations regarding the company's assets.

The bankruptcy judge may decide that the members of the company's managing bodies cannot leave the territory of the Republic of Poland without its permission.

7.2 Sanctions for breach of BARL's article 57

Under BARL's article 58, in the event the company conceals its assets in the circumstances described in question 7.1 above, the bankruptcy judge may impose coercive measures on the company to enforce performance.

The bankruptcy judge may impose coercive measures on the company if it breaches its duties or if, after the bankruptcy declaration, it commits acts intended to conceal its assets or encumber the assets with ostensible obligations or if it obstructs the identification of the property of the bankruptcy estate in any other manner.

7.3 Obligations under BARL's article 59

If bankruptcy with the possibility to make an arrangement has been declared, unless the court imposes harsher measures on the company, the company must provide the bankruptcy judge and the court supervisor with all necessary explanations regarding the company's assets, as well as enabling the court supervisor to examine the company's enterprise, in particular its book accounts.

In the event the company does not perform the duties mentioned above, the bankruptcy judge will impose coercive measures to enforce performance.

7.4 BARL's article 243

The company may also be requested by the trustee, court supervisor or administrator to provide explanations and to make a statement on whether the company acknowledges claims submitted by the creditors of the company.

7.5 BARL's article 373 paragraph 1 points 2-4

The prohibition provided for by BARL's article 373 may also be imposed against a person who by such person's fault:

(1) following the bankruptcy declaration did not release or identify the assets, records, correspondence or other documents of the company, despite being obliged to do so under BARL;

(2) following the bankruptcy declaration concealed, destroyed or encumbered the assets included in the bankruptcy estate; or

(3) as a bankrupt in the course of the bankruptcy proceedings failed to fulfil other obligations imposed upon such person by BARL or by the decision of the court or the bankruptcy judge or has in any other manner impeded the proceedings.

7.6 Human rights

7.6.1 *Constitution of the Republic of Poland*

Although not directly relating to directors or other members of corporate bodies, the Constitution of the Republic of Poland provides several guarantees of human rights (relating to court proceedings), which need to be observed in the law and acts of public authorities. These guarantees include:

(1) each person has personal inviolability and personal freedom from which he may only be deprived on the basis and in pursuance of the law;

(2) each person may be subjected to criminal liability only for committing an act punishable at the moment of its making;

(3) each person is presumed innocent until found guilty by a legally valid decision of the court;

(4) each person has a right to a fair trial.

7.6.2 *Code of Civil Procedure*

In civil procedure (of relevance to this analysis) a witness or person testifying as a party (for instance a person authorised to represent a company):

(1) may refuse to testify if that person is a spouse, ascendant, descendant or a sibling of the party or an in-law of the party (in the same line and degree), or a person in an adoptive relationship with the party;

(2) may refuse to answer a question if the answer would expose that person or that person's relatives (enumerated in point 1 above) to criminal liability, dishonour or severe and direct material loss or if the testimony of that person would be connected with the breach of a material professional secret.

7.6.3 *Code of Criminal Procedure*

Under the Polish Code of Criminal Procedure defendants and witnesses have several rights regarding their questioning. They are as follows:

(1) A defendant has a right to testify. A defendant also has a right, without giving any reasons whatsoever, to refuse to answer particular questions or to refuse to testify altogether. A defendant has to be informed about these rights.

(2) Witnesses who are under duty to keep a professional secret may refuse to testify about the circumstances relating to the secret, unless the court or prosecutor relieves them from the obligation to keep the secret.

(3) A defendant's closest person (spouse, ascendant, descendant, sibling, in-law of the same line or degree, person in an adoptive relationship or that person's spouse, and finally a person living with defendant) has a right to refuse to testify.

(4) A witness who is indicted for being an accomplice in different criminal proceedings regarding the same crime has a right to refuse to testify.

(5) A witness may refuse to answer a question if the answer would expose the witness or witness' closest person to criminal liability.

(6) A witness may request that the hearing at which the witness testifies is closed to the public if the contents of the witness' testimony would expose him or his closest person to dishonour.

(7) In the event there is a substantiated danger in relation to the life, health, freedom or property of significant value of a witness or his closest persons, the identity of the witness may be concealed by the court's or prosecutor's order.

(8) A person remaining with the defendant in a particularly close relationship may be released from the duty to testify or to answer questions, if that person brings a motion to be released.

7.6.4 *European Convention on Human Rights*

Poland is a member state of the Council of Europe and a signatory to the European Convention on Human Rights.

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 *Criminal procedure*

Under Article 101 of CrimC, the limitation period for the prosecution of the misdemeanours listed in question 2 above is:

(i) fifteen years, if the penalty provided by the law exceeds five years imprisonment;

(ii) ten years, if the penalty provided by the law exceeds three years imprisonment;

(iii) five years, in all other misdemeanours where the penalty is three years imprisonment or lower, which runs from the moment the crime is committed.

8.1.2 *Civil procedure*

8.1.2.1 Under BARL's article 377, the prohibition referred to in BARL's article 373 and 374 shall not be imposed if proceedings have not been commenced within one year of the discontinuance or closure of the bankruptcy proceedings or of the dismissal of the petition to declare bankruptcy or, if the bankruptcy petition has not been presented, – within three years of the date when the company became obliged to file the bankruptcy petition.

8.1.2.2 Under CC's article 118, as a general rule the limitation period for bringing civil claims is:

(a) if the action is brought in relation to business activities or for periodical performances – three years;

(b) in all other cases – ten years from the date on which the claim became enforceable or, if enforceability depends upon an act being undertaken by some person – from the date on which the claim would have become enforceable if that person had undertaken that act at the earliest time possible.

As for claims under CC's article 415, the limitation period is three years from the date on which the aggrieved party became aware of the damages and of a person liable to redress the damage, but no more than ten years from the date of the event causing the damage. If the damage is a result of a felony or misdemeanour, the limitation period is 20 years from the date the crime was committed no matter when the aggrieved party became aware of the damage and of the person liable to redress the damage.

8.1.2.3 Under CompC's article 297, the limitation period for bringing an action under CompC's article 293 is three years from the date on which the company became aware of the damage and of a person liable for its redress, subject to an overriding limitation period of ten years from the date of the event causing damage.

8.1.2.4 Under CompC's article 488, the limitation period for bringing an action under CompC's article 483 is three years from the date on which the company became aware of damage and of a person liable for its redress, subject to an overriding limitation period of five years from the date of the event causing damage.

8.1.2.5 Under CC's article 534, the limitation period for bringing *actio pauliana* is five years from the moment of transaction.

8.1.3 *Procedure under TOA*

According to TOA's article 118, it is forbidden to issue a decision under article 116 in the event that five years have lapsed since the end of the calendar year in which the outstanding tax obligation arose.

8.2 Appeals

Article 176 of the Constitution of the Republic of Poland provides for at least two instances in court proceedings. The court's final decisions in Poland have the form of either *postanowienie* (here, referred to as a ruling) or *wyrok* (here, referred to as a judgment). The form of decision is regulated by the law, depending on, among other things, the type and nature of the proceedings in which the decision is issued.

8.3 Criminal procedure

In criminal proceedings, all final decisions of the court are generally judgments. An appeal from each judgment issued by a court of first instance may be brought by the parties, the entity which benefited from the crime and was ordered to return the benefit and by the entity aggrieved by the crime (eg from a judgment conditionally discontinued).

An appeal in criminal proceedings must be brought within 14 days from the moment of receipt of the judgment with the court's legal opinion.

An appeal may be brought in relation to the entire judgment or part of it. It is possible to bring an appeal from the court's legal opinion only. However, the party appealing may base its appeal only on factual or legal findings which violate its rights (with the exception of public prosecutor).

There is no right to appeal decisions of the court issued in the appellate procedure.

An appeal is brought in writing to the court which issued the decision in the first instance.

Polish criminal procedure also provides for an extraordinary means of appeal – cassation (*Kasacja*) to the Supreme Court from legally valid judgments of the appellate courts ending the proceedings. Cassation may be brought once only in relation to each decision by the parties to the proceedings, the Attorney General, the Commissioner for Civil Rights Protection (*Rzecznik Praw Obywatelskich*) and, in certain cases, by the Commissioner for Child's Rights Protection (*Rzecznik Praw Dziecka*).

Cassation must be brought within 30 days from the moment of receipt of the decision with the court's legal opinion.

Grounds for bringing a cassation are enumerated and include gross procedural error and other gross infringement of the law having a material influence on the court's decision.

8.4 Civil procedure

In civil proceedings, in cases within the scope of this analysis (question 2 above), some of the final court's decisions take the form of a ruling resolving the merits of the case, hence being of the same nature as a judgment (as a general rule, proceedings under BARL) and some take the form of a judgment.

As is the case with criminal proceedings, decisions issued by a court of first instance may be appealed.
An appeal needs to be brought to the court which issued the decision within two weeks from the moment of receipt by the appealing party of the decision with the court's legal opinion.

Also, as is the case with criminal proceedings, Polish civil procedure provides for an extraordinary means of appeal – the cassation claim (*skarga kasacyjna*) to the Supreme Court for legally valid judgments (in material matters – if the value of the claim is equal to at least PLN 50,000) or holdings (regarding prohibition imposed under BARL's articles 373 and 374) may be brought by the party to the proceedings, the Attorney General, the Commissioner for Civil Rights Protection and, in certain cases, by the Commissioner for Child's Rights Protection (*Rzecznik Praw Dziecka*). The cassation claim needs to be based on either (i) infringement of a substantive law by erroneous interpretation or inappropriate application, or (ii) infringement of procedural law, if the infringement might have had material influence on the result of the proceedings. The cassation claim may not be based on claims relating to the determination of facts or the evaluation of evidence. The cassation claim needs to be brought by the party within two months from the moment of receipt of the decision with the court's legal opinion by the party bringing the claim. The Supreme Court recognises the cassation claim if: (i) a material legal question exists, (ii) there is a need to interpret legal provisions which are seriously doubtful or which are the cause of divergence in judicature of the courts, (iii) there is an invalidity of the proceedings, or (iv) the cassation claim is obviously substantiated.

8.5 Procedure under TOA

According to TOA's article 220, a decision issued by a tax office of first instance may be appealed only to one of higher instance. The appeal needs to be brought within 14 days from the moment of receipt of the decision to the office which issued such a decision.

The final decision of the tax office of higher instance may be appealed to the voivodship administrative court (*wojewódzki sąd administracyjny*). Final judgment of this court or a ruling ending the proceeding may be appealed by the cassation claim to the Principal Administrative Court (*Naczelny Sąd Administracyjny*). The cassation claim may be brought by the party, the prosecutor, the Commissioner for Civil Rights Protection and, in certain cases, by the Commissioner for Child's Rights Protection (*Rzecznik Praw Dziecka*) within 30 days from receipt of the final decision of the *voivodship* administrative court. The cassation claim needs to be based on either (i) infringement of a substantive law by erroneous interpretation or inappropriate application, or (ii) infringement of a procedural law, if such infringement might have had material influence on the result of the proceedings.

QUESTION 9

9. Foreign corporations

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

9.1 Criminal law

Pursuant to the general rules of Polish criminal law, each act committed in Polish territory and meeting the criteria provided for by Polish law constitutes a crime. Polish criminal law is also applicable to a Polish citizen who commits a crime outside of Poland. Moreover, as a general rule, Polish criminal law is applicable to a foreign person if that a person commits a crime (outside Poland) against the interests of Poland, a Polish citizen, a legal person or an entity without legal personality and if the same crime is also recognised by the law of the country in which the act was committed.

9.2 Civil law

As a general rule, the law of the country where the registered seat of the company is located governs, among other things: (i) the competence and rules of functioning and appointing and dismissing members of corporate bodies in the company, and (ii) the consequences of any breach of the law or articles of association of the company by a person representing the company.

As for the jurisdiction of Polish courts in civil cases, the general rule is that Polish courts have jurisdiction if the defendant's residence or usual place of abode or registered seat is in Poland.

9.3 Insolvency law

Under Polish law there are two bases for the treatment of foreign companies in relation to bankruptcy law and procedure – one is provided by BARL and the other is provided by the EC Regulation on Insolvency Proceedings of 29 May 2000 (which is applicable to Poland as a member state of the European Union) (ECReg).

The ECReg is applicable to EU companies and the relevant part of BARL is applicable to companies with their seats outside of the EU.

9.3.1 *EC Regulations (ECReg)*

According to ECReg's article 3 paragraph 1, the applicable jurisdiction for opening main insolvency proceedings (which is effective on all the debtor's assets and in relation to all creditors no matter where located) is the court of the member state where the debtor's centre of main interests (COMI) is located.– There is a rebuttable presumption that the COMI of the debtor (being a company or an entity with legal personality) is where its registered office is located. Otherwise COMI is not defined by the ECReg, except for the reference contained in Paragraph 13 of the preamble which provides 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.

ECReg's article 3 paragraph 2 provides for a different type of proceeding (besides main insolvency proceedings) – territorial/secondary proceedings, which may be initiated and conducted (in certain restricted circumstances) in a member state other than the member state where the debtor's COMI is located. The prerequisite for initiation of territorial/secondary proceedings is that the debtor possesses an establishment (defined as any place of operations where the debtor carries out a non-transitory economic activity with human means and goods) in the territory of that member state. Secondary insolvency proceedings are effective only in relation to the assets of the debtor located in that specific member state.

As a general rule, the law applicable to main insolvency proceedings and their effects is that of the member state within the territory in which those proceedings are opened. The applicable law determines, among other things, the rules relating to voidness, voidability or unenforceability of legal acts detrimental to creditors, unless the person who benefited from the detrimental act provides proof that:

- the act is subject to the law of a member state other than that of the state of the opening of proceedings; and

- that law does not allow any means of challenging that act in the relevant case.

ECReg provides for the recognition of insolvency proceedings. Under ECReg's article 16, any judgment opening insolvency proceedings handed down by a court of a member state which has jurisdiction pursuant to article 3 must be recognised in all other member states from the time that it becomes effective in the state of the opening of proceedings. Recognition of main proceedings does not preclude the opening of secondary proceedings by a court in another member state. As a general rule, the effect of the recognition is that the judgment opening main proceedings produces the same effects in any other member state.

Finally, ECReg's Chapter III regulates secondary insolvency proceedings. Under ECReg's article 27, the opening of secondary proceedings by a court of a member state and which is recognised in another member state (main proceedings) permits the opening in that other member state, of secondary insolvency proceedings without the debtor's insolvency being examined in that other member state. Their effects shall be restricted to the assets of the debtor situated within the territory of that other member state. As a general rule, the law applicable to secondary proceedings is that of the member state within the territory in which the secondary proceedings are opened. The opening of secondary proceedings may be requested by:

(a) the liquidator in the main proceedings;

(b) any other person or authority empowered to request the opening of insolvency proceedings under the law of the member state within the territory in which the opening of secondary proceedings is requested.

9.3.2 *BARL*

BARL's Part II is applicable in relation to international bankruptcy proceedings, unless an international agreement to which Poland is a party or the law of an international organisation of which Poland is a member provides otherwise.

As provided by BARL's article 382, the Polish courts have exclusive jurisdiction in bankruptcy cases if the debtor has the main centre of its business activities in Poland. Additionally, Polish courts have jurisdiction if the debtor conducts business activities or has its seat or assets located in Poland.

As a general rule, a creditor having a domicile or registered seat outside Poland has the same rights in bankruptcy proceedings as a domestic creditor.

In the event the main centre of a debtor's business activities is located outside Poland, bankruptcy proceedings initiated by the Polish court will only encompass the debtor's assets which are located in Poland.

Just like the ECReg, BARL regulates the recognition of foreign bankruptcy proceedings. As a general rule BARL's provisions regulating the commencement of bankruptcy proceedings and the bankruptcy declaration govern the process for recognising foreign bankruptcy proceedings. Such foreign proceedings will be recognised if:

(1) the proceedings relate to a matter over which the Polish courts have no exclusive jurisdiction;

(2) recognition is not contrary to the fundamental principles of the legal order in Poland.

On the day of recognition of foreign insolvency proceedings, by virtue of law:

(1) court proceedings relating to the bankrupt's assets and execution proceedings against the bankrupt's assets are stayed;

(2) the bankrupt loses the right to manage and dispose of its assets unless proceedings have been opened which include the possibility of making a composition arrangement and the bankrupt has retained administration.

After foreign bankruptcy proceedings have been recognised, the foreign representative (that is, a person or body appointed in the foreign bankruptcy proceedings whose function is to administer, reorganise or liquidate the debtor's assets) may present a bankruptcy petition and participate in bankruptcy proceedings conducted by the Polish courts in the same way as creditors.

If foreign bankruptcy proceedings have been recognised, the effects of bankruptcy with regard to the bankrupt's assets situate in Poland, and with regard to obligations which have arisen or which are to be performed in Poland, are determined pursuant to Polish law. The ineffectiveness of, and any challenge to, the bankrupt's acts relating to assets located in Poland included in the bankruptcy estate is determined pursuant to Polish law.

Recognition of foreign bankruptcy proceedings does not prevent a Polish court from opening bankruptcy proceedings. If, however, the main foreign bankruptcy proceedings (that is insolvency proceedings conducted in the state where the debtor has the main centre of its business activities, the rebuttable presumption being that the debtor's main centre of business activities is located in the state of its registered seat) have been recognised, the proceedings opened in Poland will be secondary bankruptcy proceedings and encompass only the debtor's assets located in Poland.

BARL also recognises ancillary foreign bankruptcy proceedings – that is, foreign bankruptcy proceedings other than main foreign bankruptcy proceedings conducted in the state where the debtor conducts its business activities. If ancillary foreign bankruptcy proceedings are recognised, the bankruptcy proceedings in Poland will be conducted pursuant to general rules.

In the event the main foreign bankruptcy proceedings are recognised, it is presumed that the debtor is insolvent.

QUESTION 10

10. Insurance

Is directors' and officers' insurance available in your jurisdictions? 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 Although not directly regulated by the law, civil liability insurance policies designed for the members of corporate bodies are offered by major insurers in the Polish market. The premiums may be paid either by the company or by the natural person holding a position of director or other position which may be covered by an insurance policy.

10.2 Often, not all the persons who may be held liable as a result of their position within the company will be protected by such insurance, depending on the general terms of insurance of each insurer.

10.3 Insurance of this kind covers civil liability (generally including the costs of court representation) for damages caused to third parties and the company in the course of performing membership duties of the relevant corporate body. The insurance coverage may be extended, but it does not cover civil liability resulting from deliberate acts of the insured person.

QUESTION 11

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

11.1 As noted throughout this analysis, incurring credit on behalf of the company during the twilight period may bring various consequences.

11.2 Firstly, some transactions (listed above) entered into by the company during the twilight period are either ineffective *ex lege* or may be held to be ineffective by the court. Secondly, directors of the company (or other persons listed above) may be held liable, under either civil or criminal law, for acts in their capacity as the company's representatives.

As a result, representatives of the company have to remain extremely vigilant at all times whilst they hold their position in the company and perform their obligations connected with their function. Obligations and duties of directors and other persons similarly liable for the well-being of the company are listed above. There are, however, some important duties worth mentioning at this point. First of all, directors need to react instantly as soon as the grounds for bankruptcy declaration arise. Secondly, they have to be careful in incurring further credit and entering into transactions during this period when the company is vulnerable to insolvency or when the grounds for declaring bankruptcy start to exist – each erroneous decision (in some instances even if inadvertently taken) may result in directors' civil or criminal liability.

11.3 Although it is possible for directors and others to insure themselves against civil liability connected with their function, Polish insurers generally do not provide cover from deliberate acts resulting in damages. Hence, directors need to remember that in several instances there is no way "off the hook" as regards entities dealing with the company or entities which suffer damage as a result of the company's acts.

11.4 At all times directors need to keep in mind that professional and reliable legal and financial assistance rendered by specialised persons and offices is an alternative to a mere insurance policy. Specially qualified attorneys and financial advisors may not only be helpful during court and other proceedings subsequent to the company's bankruptcy, but first and foremost they are the best means of ensuring that no grounds for holding the directors liable – under either civil or criminal law – exist.

APPENDIX

Summary of Polish bankruptcy and reorganisation law and procedure

1. Introduction

1.1 The bankruptcy procedure applies to debtors who are entrepreneurs, where the entrepreneur's status may accrue to a natural person as well as to a legal person or a business entity with legal capability, conducting business or professional activity on its own behalf. In addition, the bankruptcy procedure applies to limited liability companies and joint stock companies even if they do not conduct business activities.

1.2 Under BARL there is a single type of bankruptcy procedure which may, however, be conducted in one of two possible ways:

(a) liquidation of the debtor's assets and pro rata distribution of the bankruptcy estate funds according to statutory sequence of classes of claims; or

(b) preservation of the debtor's business activity through a composition of arrangement, which is subject to creditors' approval and final approval by the court.

1.3 Additionally, there is a separate reorganisation procedure in the event there is a threat of insolvency. The goal of this procedure is to open the way for a composition arrangement between the debtor and his creditors.

2. Insolvency

2.1 Bankruptcy is declared in relation to a debtor who has become insolvent.

2.2 The debtor is deemed insolvent if the debtor fails to perform its due pecuniary liabilities (insolvency test).

2.3 Moreover, a debtor being a legal person or a business entity with legal capability is also deemed insolvent when its liabilities exceed the value of its assets, even though the debtor duly performs those liabilities (balance sheet test).

3. Bankruptcy procedure

3.1 The bankruptcy procedure may be initiated (by presenting a bankruptcy petition) by the debtor, pursuant to his obligation to do so within two weeks from the date on which the grounds for a bankruptcy declaration first arose, or voluntarily by any of his creditors. The bankruptcy petition will indicate whether the petitioner applies for a bankruptcy with liquidation of the bankruptcy estate or with a composition arrangement. Once the court accepts the bankruptcy petition, the bankruptcy is declared.

3.2 If it is determined that under a composition arrangement, creditors are likely to be satisfied to a higher degree than they would be as a result of a bankruptcy procedure comprising the liquidation of the debtor's assets, the court will declare bankruptcy with the possibility of making a composition arrangement. Such a decision may not, however, be undertaken if, in view of the debtor's previous conduct, it is not certain that the arrangement will be performed. Moreover, if an initial creditors' meeting was convened and adopted a resolution concerning the method of conducting the bankruptcy, the court should respect that resolution unless it is contrary to law.

3.3 The court may modify the bankruptcy procedure's direction (that is liquidation or composition agreement), provided that grounds substantiating the modification are disclosed in the declaration of bankruptcy.

3.4 In the case of a composition bankruptcy, for the purpose of voting on the composition arrangement, the bankruptcy judge may decide that voting is to be made by groups of creditors. In this event, the bankruptcy judge will prepare separate lists of creditors who are entitled to vote, representing separate classes of interests. The separate lists may include:

(a) creditors entitled to receivables arising under an employment relationship, who have consented to be included in a composition agreement;

(b) farmers entitled to receivables arising under agreements for the supply of products from their own farms;

(c) creditors whose claims are secured on the bankrupt's assets by mortgage, pledge, registered pledge, treasury pledge or maritime mortgage, and also by transfer to the creditor of ownership of property, claims or other right, and who have consented to be included in]a composition agreement;

(d) creditors who are shareholders or stockholders of the bankrupt, which is a limited liability or joint stock company, who hold shares in the company with at least 5% of votes at a shareholders' meeting, even if they hold claims listed in points a) - c); and

(e) other creditors.

A composition agreement is adopted if it is voted for by the majority of creditors entitled to vote, who hold jointly at least two thirds of the aggregate value of claims entitling them to vote. If voting in favour of a composition arrangement is made in groups of creditors encompassing specific classes of interests, the composition arrangement will be adopted if voted for in each group by a majority of the creditors from the group, holding jointly at least two thirds of the total value of claims encompassed by the separate list of creditors entitled to vote.

The composition arrangement is adopted even if the required majority of votes of creditors from some of the lists of creditors is not reached, if the majority of creditors from the remaining groups, holding jointly two thirds of the aggregate value of claims entitling them to vote, consent to the adoption of the composition arrangement, and if creditors from a group or groups who voted against the composition arrangement will be satisfied under the composition arrangement to a degree not less beneficial than if a bankruptcy procedure comprising the liquidation of the bankrupt's assets were conducted.

Subsequently, the composition arrangement is confirmed by the bankruptcy judge.

If the composition arrangement is not adopted, the court will immediately convert the method of conducting the bankruptcy procedure from a bankruptcy procedure with the possibility to make an arrangement into a bankruptcy procedure comprising the liquidation of the bankrupt's assets, and the court will appoint the trustee. In these circumstances, it is not possible to propose another composition arrangement.

The composition arrangement adopted by the meeting of creditors is approved by the court.

The composition arrangement is binding upon all creditors whose claims are, under BARL, included in the composition arrangement, even if not recorded on the list. However, the composition arrangement is not binding upon those creditors whose existence the bankrupt intentionally concealed and who have not participated in the procedure.

4. Effects of bankruptcy declaration with respect to the bankrupt's obligations

On the day the bankruptcy declaration is issued, the bankrupt's property becomes the bankruptcy estate from which to satisfy the claims of the bankrupt's creditors.

4.1 Bankruptcy declaration – with the possibility of a composition arrangement.

A court supervisor (*nadzorca sądowy*) (in the event the bankrupt retains the right to manage its entire property) or an administrator (*zarządca*) (in the event the bankrupt is deprived of the right to manage at least a part of its property) is appointed.

As a general principle, neither the bankrupt nor the administrator may render performances which are included in the composition agreement.

4.2 Bankruptcy declaration – liquidation of the bankrupt's assets.

A trustee (*syndyk*) is appointed.

Pecuniary obligations of the bankrupt, not yet payable, become payable on the date the bankruptcy declaration is issued. Non-pecuniary material obligations are, on the date of the bankruptcy declaration, converted into pecuniary obligations and become payable even though their performance date has not yet arisen.

As a general rule, the set-off of the bankrupt's claim against claims of a creditor is admissible if both claims existed on the date of the bankruptcy declaration, even if one of them was not yet payable. A creditor intending to exercise set-off needs to make a relevant declaration no later than at the time of filing its claim.

5. Ineffectiveness of and challenging the bankrupt's transactions

Please see answers to questions 1 and 4.

6. Order of satisfaction of unsecured claims – liquidation of the bankrupt's assets

6.1 Amounts subject to satisfaction from the bankruptcy estate funds fall into five classes of priority (higher classes having priority over lower classes):

(a) class one – costs of the bankruptcy procedure, alimony and pension payments for causing illness, inability to work, disability or death due for the period following the declaration of bankruptcy and pension payments by virtue of a change of rights under a life estate (*prawo dożywocia*) into a life-long pension, amounts which unjustly enriched the bankruptcy estate, amounts from agreements executed by the bankrupt prior to the declaration of bankruptcy, the performance of which was requested by the trustee, amounts from the trustee's or administrator's acts, amounts which were created by acts of the bankrupt following the bankruptcy declaration and did not require permission of a court supervisor or were performed with the permission of a court supervisor;

(b) class two – amounts due for the period prior to declaration of the bankruptcy arising under an employment relationship, farmers' receivables arising under agreements for the supply of products from their own farms, alimony and pension payments for causing illness, inability to work, disability or death and pension payments by virtue of a change of rights under a life estate (*prawo dożywocia*) into a life-long pension, social security contributions together with due interest and execution costs due for the last two years prior to the declaration of bankruptcy;

(c) class three – taxes and other public payments and outstanding social security contributions together with due interest and execution costs;

(d) class four – other amounts if they are not subject to class five, together with the interest due for the year preceding the date of the bankruptcy declaration, liquidated damages, costs of the procedure and execution;

(e) class five – interest not included in the classes of higher priority, to be satisfied in the order in which the principal amount is to be satisfied, as well as court and administrative fines and amounts resulting from donations and legacies.

6.2 A claim acquired after a bankruptcy declaration is issued by way of an assignment or endorsement is subject to satisfaction within class three, provided that it is not subject to satisfaction within class four.

6.3 The trustee prepares and submits to the bankruptcy judge a plan which forms the basis of the distribution of the bankruptcy estate funds. The bankruptcy judge may amend the plan or may order the trustee to amend the plan as instructed.

7. Claims secured by rights *in rem*

BARL introduced a separate distribution regime relating to proceeds obtained from the sale of encumbered assets. As a general rule, claims secured by a mortgage, pledge, registered pledge, treasury pledge and maritime mortgage, as well as certain rights expiring under BARL relating to real property or sea vessels, are satisfied from the proceeds of the liquidation of the encumbered asset, less the costs connected with the liquidation of the asset and other costs of the bankruptcy procedure (such "reduction amount" is, however, limited to a certain level, as provided by BARL). After covering the above costs, the proceeds are divided between the secured creditors in accordance with their priorities.

In the case of a sale of real property or a sea vessel registered with the register of vessels, prior to satisfaction of claims secured by a mortgage or maritime mortgage and other rights, certain types of claims (which include alimony claims, pension payments for causing illness, inability to work, disability or death and pension payments by virtue of change of rights under life estate (*prawo dożywocia*) into a life-long pension, as well as remuneration claims of the employees working on such real property or sea vessel) will have priority and must be satisfied before the secured claims.

8. Reorganisation procedure

8.1 The reorganisation procedure is initiated voluntarily by an entrepreneur threatened (but not yet insolvent) with insolvency.

8.2 The entrepreneur submits to court a statement on opening a reorganisation procedure and a reorganisation plan.

8.3 The main goal of the reorganisation procedure is to restore the entrepreneur's ability to compete in the market.

8.4 The obligations of the debtor are restructured by way of a composition arrangement adopted at a meeting of creditors which needs to be voted for by the majority of creditors. Thereafter, the arrangement is approved by the court.

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

Most of the legislation relevant to insolvency of corporate entities in Russia is contained in Federal Law No. 127-FZ on Insolvency (Bankruptcy) of 26 October 2002 (the Insolvency Law).

Insolvency of banks and credit organisations is regulated by a separate law, but these entities are outside the scope of this note.

The Insolvency Law was subject to significant amendments in the middle of 2009 which, among other things, significantly developed a concept of vulnerable transactions and set out in greater detail the grounds, the procedure and consequences of their challenge. In addition, such amendments introduced the concept of 'controlling persons' (which arguably includes the chief executive officer and members of the board of directors of the company) and expanded the grounds giving rise to liability of directors and other controlling persons for actions during the period preceding bankruptcy of a company.

Provisions regarding some areas of insolvency and liability of directors and officers and third parties are also included in the Civil Code of the Russian Federation (the Civil Code); 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 (the JSC Law) and Federal Law of the Russian Federation No. 14-FZ on Limited Liability Companies of 8 February 1998 (the LLC Law).

Bankruptcy cases in Russia are heard by 'arbitrazh courts' located in the area where the debtor is registered which, for ease of reference, we refer to as bankruptcy courts.

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 (*nablyudeniye*), a preliminary compulsory stage of insolvency proceedings intended to conduct a financial audit with the purpose of determining whether the debtor may be restored to solvency, securing its assets, drawing up an initial register of creditors' claims and convening the first creditors' meeting;

(b) financial rehabilitation /recovery (*finansovoye ozdorovleniye*), a non-compulsory 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 (*vneshneye upravleniye*), a non-compulsory stage, in which the current ownership structure of the debtor is maintained pending its efforts to regain solvency;

(d) liquidation (*konkursnoye proizvodstvo*), i.e. winding-up; and

(e) entry into a voluntary arrangement (mirovoye soglasheniye), which does not, strictly speaking, constitute a separate stage of the insolvency proceedings, but rather the successful outcome of any of the other stages.

Russian bankruptcy laws focus primarily on various procedures to protect the rights of creditors in the course of insolvency proceedings and attempt to make the debtor solvent again. Although three years on from the introduction of the amendments to the Insolvency Law, the concept of the liability of directors and others involved in the management of the company is far from being sufficiently and clearly regulated. In addition, despite amendments a few years ago to the provisions on the challenges which may be brought in respect of transactions entered into by a company which consequently becomes insolvent, there is no direct connection between vulnerable transactions and the liability of members of the company's management bodies and other controlling persons for the approval, conclusion and performance of such transactions during the period preceding the formal bankruptcy of a company.

1.3 "Twilight" period(s)

1.3.1 *Determining the "twilight" period*

It is generally accepted that the twilight period refers to a period which begins when a company's solvency is in doubt and the company satisfies the relevant insolvency test and ends with the commencement of the formal insolvency proceedings. During the twilight period directors should act cautiously in order to avoid becoming personally liable for the debts incurred as a result of transactions entered into or performed during this period if the company subsequently goes into a formal bankruptcy process.

As regards Russian insolvency law, there is a three-year look-back period during which certain transactions entered into or performed by a debtor may be susceptible to attack (for grounds of challenge and other details see Section 1.6 and Section 4.3). However, as a matter of the Insolvency Law, it is not necessary for a successful challenge of such transactions to show that at the moment of their conclusion or performance the debtor showed the signs of bankruptcy or that as a result of performance of such transactions the debtor became insolvent. Furthermore, in order to challenge a vulnerable transaction it is not necessary that at the moment of the entry into of such a transaction the chief executive officer or any other controlling person of the debtor knew or should have known that the debtor had the signs of bankruptcy or otherwise satisfied the insolvency test or that there was no reasonable prospect of avoiding bankrupt liquidation. The signs of bankruptcy are mentioned by law along with other qualifying challenges and in certain cases may extend the vulnerability periods.

Moreover, Russian law does not directly correlate the personal liability of a director or any other controlling person with their knowledge or belief that at the moment of conclusion or performance of a vulnerable transaction the debtor may have encountered the signs of bankruptcy. Only in the case of liability of controlling persons is the loss caused to creditors as a result of the instructions of the controlling persons to the debtor taken into account and the level of liability may be affected by the actual loss caused to creditors as a result of following such instructions. However, as the concept of controlling persons' liability is new to Russian law, it still remains unclear whether in order to impose a personal liability on a controlling person it is necessary to prove that the instructions of that controlling person resulted in the debtor's insolvency.

Having said that, under Russian law one of the twilight periods during which a chief executive officer (or any other person acting in the name of the debtor without a power of attorney) (the CEO) may be exposed to personal liability is deemed to begin when the company meets any of the insolvency criteria set out in the Insolvency Law and ends with the filing of a bankruptcy petition (see Section 1.3.4 for details) ('twilight period for failing to file'). This twilight period entails certain duties of the CEO, which are discussed in Section 1.3.4 below.

1.3.2 *Duty of the CEO to inform the shareholders / participants about the debtor showing signs of bankruptcy*

Under the Insolvency Law the company is deemed to have 'signs of bankruptcy' if it is not able to satisfy the monetary claims of its creditors (provided that the unpaid debt is overdue for at least three months from the date when it was due to be repaid).

If a company shows signs of bankruptcy:

(i) the CEO must inform the founders (shareholders/participants) of the company that the company has signs of bankruptcy;

(ii) the founders (shareholders/participants) of the company are required by law to take measures to restore the debtor's solvency;

The above steps are referred to as 'bankruptcy prevention' measures but they essentially aim to prevent the commencement of formal bankruptcy proceedings.

Although such a duty is envisaged by the Insolvency Law, there are no specific provisions relating to the liability of the CEO for failing to inform the shareholders/participants of the company where it shows signs of bankruptcy. The Insolvency Law contains a general provision that the debtor's CEO, other members of the debtor's management bodies and its shareholders/participants are liable for damages arising as a result of the breach by such persons of the Insolvency Law.

1.3.3 *Duty of the founders (shareholders / participants)*

As mentioned above, 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. According to the Insolvency Law, these measures can be undertaken not only by the founders (shareholders/participants) of the company but also 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 (sanatsiya). Rehabilitation is financial assistance to the debtor in an amount sufficient to satisfy monetary obligations, to make mandatory payments (e.g. 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 providers of such financial assistance.

1.3.4 *Duty to file a bankruptcy petition – "twilight" period for failing to file*

The Insolvency Law provides for the obligation of the CEO of the debtor to petition a bankruptcy court for commencement of insolvency proceedings within one month of it becoming evident that the debtor meets any of the following insolvency criteria:

(a) the settlement of claims of one or more creditors will result in the debtor being unable to perform its payment obligations, including mandatory payments[1], to other creditors;

(b) the shareholders (or those authorised by them) take a decision to file such a petition;

(c) the enforcement of claims against the debtor's assets will make it significantly difficult or impossible for the debtor to continue operations;

(d) the debtor (i) ceases to pay any part of its debts as they fall due on account of insufficiency of funds ('inability to pay') or (ii) has assets insufficient in value to discharge its monetary liabilities ('insufficiency of assets');

(e) in the course of a solvent liquidation of the debtor, either of the tests referred to in (d) above is met (in which case a bankruptcy petition must be filed by the liquidation commission with a bankruptcy court within ten days of such test being met); or

(f) in other cases provided by the Insolvency Law.

In certain cases such petition should be filed by the liquidator and the other members of the liquidation commission or by the CEO of the debtor together with the founders (shareholders/participants) of the debtor (see Section 3).

Failure to file the petition results in secondary liability of persons in whom the duty to file for bankruptcy is vested. Such secondary liability covers the new debts arising after the expiration of the period envisaged for filing a bankruptcy petition.

The bankruptcy petition can be also filed by a creditor and with respect to mandatory payments by certain authorised government agencies. Before a creditor can commence insolvency proceedings, it must obtain a court judgment against the debtor. The creditor may petition for the debtor's bankruptcy if the amount of a debt confirmed by the court judgment is not less than RUR 100,000, is overdue by at least three months and the court judgment confirming such debt has entered into force.

An authorised government agency may [but is not obliged to] petition for bankruptcy of a debtor (to collect outstanding mandatory payments) only after 30 days have lapsed from the date on which such agency took a decision to seize the debtor's assets to satisfy the mandatory payments or the date when a court decision to recover mandatory payments entered into force, as the case may be. The debtor therefore has a sort of a 30-day grace period during which it may discharge its obligations before the relevant authorised government agency, while the latter may not initiate bankruptcy proceedings against the debtor earlier than this 30-days period has expired.

1.3.5 *Liability of controlling persons – another twilight period*

Another twilight period was introduced in mid-2009 when the concept of personal liability of controlling persons (which arguably includes the CEO and members of the board of directors of the debtor, see 3.3 for details) was incorporated into the Insolvency Law ('twilight period for controlling persons'). Such persons could jointly and severally bear secondary liability for monetary claims of creditors against the debtor on the basis of the claims for damages caused to creditors when simultaneously:

(a) the insolvent debtor has acted on instructions from its controlling persons;

(b) such actions resulted in a 'harm to creditors' rights' (i.e. the decrease of the value or size of the debtor's assets and/or the increase of the size of claims against the debtor as well as other consequences of the debtors' acts or transactions resulting in it becoming impossible for the creditors to have debts due from the debtor repaid (in part or in full) from the debtor's assets); and

(c) the bankruptcy estate is insufficient to satisfy the creditors' claims.

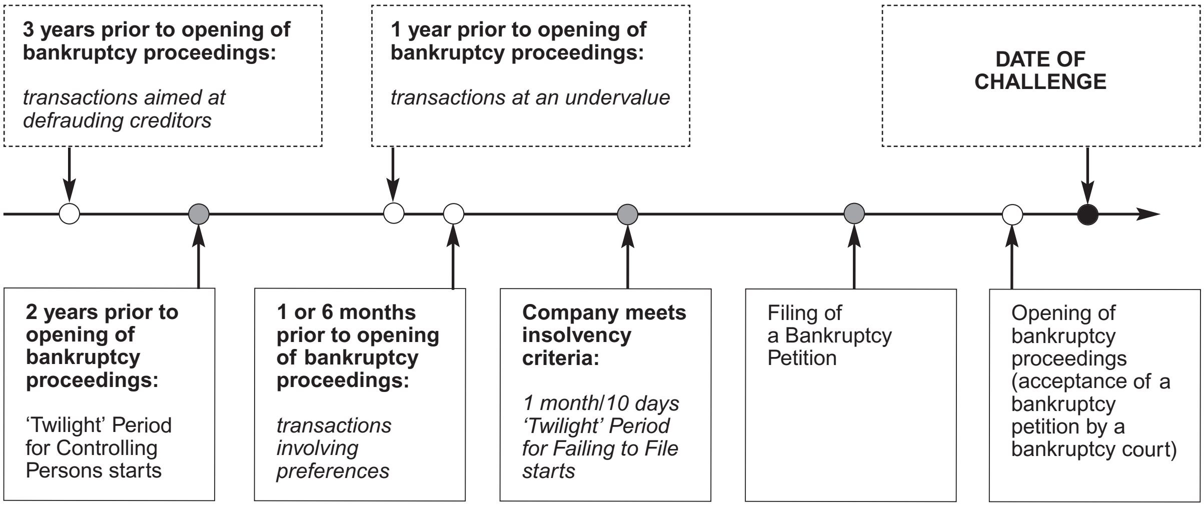
The twilight period to trigger the above liability is set within two years preceding the commencement of insolvency proceedings during which such controlling persons were entitled to give binding instructions to the debtor or were able to determine the actions of the debtor. For more details, in particular as to which persons may be considered as controlling persons under the Insolvency Law, see Section 3.3.

1.4 Challenging transactions in bankruptcy

According to Russian law, transactions entered into by the debtor prior to the commencement of insolvency proceedings may be challenged on various grounds (see Section 4).

1 Debts owed to the state budget or otherwise to the Russian Federation.

This may be illustrated by the following diagram:



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 formal insolvency proceedings 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 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)[2] 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[3] 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 its day-to-day activities. Members of the management 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 Liability for debts to creditors unsatisfied by virtue of insufficiency of the debtor's assets

According to the Insolvency Law, the controlling persons (which arguably includes the CEO and members of the board of directors of the debtor) may be liable in the amount insufficient to satisfy the creditors' claims included in the register of creditors as a result of insufficiency of the debtor's assets as of the date when payments to discharge such creditors' claims have been stopped.

[2] Under Russian law the terms 'board of directors' and 'supervisory board' are synonymous.

[3] In brief, an 'interested party' transaction is a transaction where any of: a member of the board of directors of a company, the CEO of a company, a member of the management board of a company or a shareholder owing alone or jointly with its affiliates at least 20 per cent of the voting shares of a company, as well as a person who has authority to issue instructions mandatory for the company has an interest in that company entering into and performing its obligations under the relevant transaction. What constitutes an 'interest' is further described in the JSC Law and the LLC Law. Under Russian law 'interested party' transactions are subject to special corporate approvals. The 'interested party' transaction and a 'transaction with an interested person' should be distinguished.

As a defence, controlling persons may prove that they acted in good faith and reasonably in the interests of the debtor in which case they may be exempt from liability. Furthermore, a bankruptcy court may reduce the liability of a controlling person if the loss caused to creditors by the debtor acting on the controlling person's instructions was disproportionately lower than the amount claimed by a creditor from such a controlling person. The controlling person who is held liable also has a right of recourse against the persons who caused the actual loss to creditors.

2.3 Civil liability of members of the board of directors

2.3.1 *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 company.[4]

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).[5]

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 their fault, with the requirement that they should act reasonably and in good faith when exercising their rights and fulfilling their obligations.

A person is deemed to be at fault under that degree of care and circumspection which was required of that person according to the nature of the obligation and the conditions in the course of business, such a person did not take all possible measures for proper performance of the obligation.[6] The damages are to be compensated in full, including loss of profit.

The civil liability of the CEO, owners of the company and, potentially, its directors is further described in Section 3.

2.3.2 *Liability for insolvency (bankruptcy) of a company*

(a) The Civil Code provisions

The Civil Code[7] provides that, in the event of the bankruptcy of a company resulting from the actions of 'persons who have the power to give instructions binding for such company' or by persons who 'otherwise have the ability to determine the actions of the company', such persons can bear secondary liability for the obligations of that company in the event such company has insufficient assets.

While these provisions of the Civil Code are mainly focused 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 Limited Liability Company Law provisions (LLC Law)

The LLC Law contains provisions very similar to those of the Civil Code. If the bankruptcy of a limited liability company is occasioned by its participants or other persons who have the right to give mandatory instructions binding for such company or otherwise determine the actions of that limited liability company such persons may bear secondary liability for the obligations of that company.[8]

(c) The Joint Stock Company Law provisions (JSC Law)

In contrast with the Civil Code and the LLC Law, the JSC Law contains provisions that appear to restrict considerably the scope of potential liability to which persons who have the right to determine the actions of a company may be exposed in case of its insolvency. Namely, the JSC Law imposes a restricted standard of potential liability to those situations where such members 'have used their right to exercise control over the company knowing in advance that such action would bring about the company's insolvency (bankruptcy)'.[9] 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 and the JSC Law could be the subject of dispute in the event of legal action with respect to their applicability.

In addition to this, liability of controlling persons (which arguably includes the CEO and members of the board of directors of the debtor) is also regulated under the Insolvency Law. Please refer to Section 2.2 and Section 3.

2.4 General criminal liability of members of the board of directors

2.4.1 *General principles*

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 CEO 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 could occur if a member of the board of directors directly and knowingly decides or takes any action which is prohibited under the applicable criminal legislation.

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[4] Article 53 of the Civil Code.
[5] Article 71 of the JSC Law and Article 44 of the LLC Law.
[6] Article 401 of the Civil Code.
[7] Article 56 of the Civil Code.
[8] Article 3 of the LLC Law.
[9] Article 3 of the JSC Law.

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' periods as well.

2.4.2 *General criminal liability applicable to members of the board of directors of a company*

The Criminal Code[10] 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.

2.4.3 *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) is subject to a fine or, in certain cases, imprisonment. The same actions involving substantial amounts are punishable by imprisonment together with possible confiscation of personal property.[11] A member of the board of directors of a company may be subject to this liability if he is adjudged guilty of such activities by a court.

2.4.4 *Criminal liability for illegally obtaining and disclosing commercial, tax or banking secrets*

The Criminal Code[12] 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 who becomes aware of such secrets while being employed with that company. A member of the board of directors may be subject to criminal liability under this article. The punishment includes, inter alia, a fine and imprisonment.

2.4.5 *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 a third party with the aim of performing actions (inaction) in favour of such third party.[13]

2.4.6 *Criminal liability for unlawful business activity*

A member of the board of directors of a company may be held liable 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.[14] Sanctions may include a fine, community works or imprisonment.

2.5 General administrative liability of members of the board of directors

2.5.1 *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.[15] A member of the board of directors may be subject to administrative liability under this article. The sanction for this offence is a fine or disqualification for up to three years.

2.5.2 *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.[16] The basic sanction for this offence is an administrative fine.

2.6 Criminal and administrative liability for illegal actions before and during the bankruptcy

2.6.1 *Criminal liability*

The Criminal Code imposes criminal liability for certain actions (or omissions) in anticipation of bankruptcy as well as for certain actions taken during the bankruptcy of a company.

In particular, the Criminal Code imposes criminal liability for the following:

(a) deliberate bankruptcy,[17] i.e. taking actions (or failing to act) by the CEO or a founder (shareholder/participant) of the company knowingly entailing its inability to satisfy in full creditors' claims;

(b) fraudulent bankruptcy,[18] i.e. the CEO or a founder (shareholder/participant) of the company knowingly makes fraudulent public declaration of bankruptcy of that company;

(c) unlawful actions during bankruptcy proceedings that fall under three categories:

[10] Article 201 of the Criminal Code.
[11] Articles 174 and 174.1 of the Criminal Code.
[12] Article 183 of the Criminal Code.
[13] Article 204 of the Criminal Code.
[14] Article 171 of the Criminal Code.
[15] Article 15.27 of the Administrative Offences Code.
[16] Article 14.1 of the Administrative Offences Code.
[17] Article 196 of the Criminal Code.
[18] Article 197 of the Criminal Code.

(i) concealing property, property rights or liabilities; withholding information on property, its size, location or any other information on property, property rights or liabilities; transferring property to others, alienating or destroying property and concealing, destroying or falsifying accounting documents; if such actions have been taken when the company has shown signs of bankruptcy;

(ii) the unlawful satisfaction of claims of certain creditors out of the company's property by the CEO or a founder (shareholder/participant) of that company in the knowledge that they will be to the detriment of other creditors; if such actions have been taken when the company has shown signs of the bankruptcy;

(iii) the unlawful actions aimed at impeding the activity of a court appointed administrator or a temporary administration of a credit organisation, including evading transfer of the documents necessary for performance of their duties or the debtor's property or refusal to do same, where the management power of the debtor's CEO is vested in a court administrator or a temporary administration of a credit organisation respectively.

For such actions to constitute a crime, substantial damage must be caused.

In relation to the category of criminal liability referred to in paragraph (c) (ii) above, the CEO or a founder (shareholder/participant) of the company can be criminally liable if: (i) there is unlawful satisfaction of a claim; (ii) there is detriment to other creditors in the form of substantial damage; and (iii) the debtor shows signs of bankruptcy.

(a) 'Unlawful satisfaction'

The meaning of 'unlawful satisfaction' is not clear. One interpretation is the satisfaction of certain creditors in violation of the order of priorities established by the Insolvency Law. Another interpretation is a payment made in violation of the law (e.g. a payment made from an account under arrest, or a payment under an invalid transaction).

(b) 'Substantial damage'

Arguably any payment reducing the amount of assets available for distribution to other creditors can result in 'substantial damage'. Such other creditors can argue that the difference between what they have received and what they would have received if a payment had not been made represents their losses (which could be considered by a court as substantial).

(c) 'Signs of bankruptcy'

The signs of bankruptcy are described in 1.3.2 above (i.e. a legal entity is unable to meet claims within three months of them becoming due.)

The category of actions mentioned in paragraph (c) (iii) will invoke criminal liability only where the management power of the debtor's CEO is vested in a court administrator or a temporary administration of a credit organisation.

The provisions of the Criminal Code are likely to apply to members of the board of directors as well.

The criminal offences mentioned above are subject to a fine; community, mandatory or correctional works, retention or imprisonment and a fine.

2.6.2 *Administrative liability*

The Administrative Offences Code also imposes liability with respect to bankruptcy.[19] This includes the following offences:

(a) fraudulent bankruptcy, i.e. the CEO or a founder (owner) of the company knowingly makes a fraudulent public declaration of bankruptcy of that company;

(b) deliberate bankruptcy, i.e. the CEO or owner of the company takes action (or fails to take action) wilfully causing or contributing to insolvency;

(c) impeding the activity of a temporary administration of a credit organisation by the CEO or other directors of that credit organisation;

(d) unlawful actions during bankruptcy, already mentioned above (see 2.5.1), provided that it does not involve criminally punishable acts;

(e) the acceptance by a creditor of the unlawful satisfaction from an insolvent debtor knowing of its preference and its ability to prejudice other creditors; if such actions have been taken when the debtor has shown signs of bankruptcy;

(f) failure by a court-appointed administrator or a head of the temporary administration of a credit organisation to perform their obligations provided for in the Insolvency Law; provided that it does not involve criminally punishable acts; and

(g) failure to file a debtor's bankruptcy petition by the debtor's CEO in the cases provided for in the Insolvency Law.

Liability for the above offences can take the form of an administrative fine or a disqualification.

Sanctions for civil, criminal and administrative offences connected with bankruptcy are further described in Section 6.

[19] Articles 14.12 and 14.13 of the Administrative Offences Code.

2.6.3 *Summary*

Although the general nature of administrative and criminal offences is similar these offences should be differentiated. The fundamental difference is the scope of the damage caused by an offence. While the Administrative Offences Code does not specify the amount or scope of the damages caused by an offence, it contains a provision that an offence qualifies as an administrative one if it does not involve an act subject to a criminal sanction. The Criminal Code provides that illegal actions during bankruptcy which have caused substantial damage may result in criminal liability. The degree of damage is, therefore, the main distinctive criterion.

With respect to fraudulent and deliberate bankruptcy both the Administrative Offences and the Criminal Codes imply that there must be a direct intent in committing such offences.

2.7 Defences

2.7.1 *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 caused. Reasonable actions imply actions of a person with normal levels of judgment and intelligence in a specific situation.

Members of the board of directors that are able to prove to court that they were acting within a reasonable level of commercial risk for the benefit of the company are not likely to be held liable for losses caused to the company by their actions during the ‘twilight’ period.

2.7.2 *Defences in criminal proceedings*

Russian criminal law does not provide for special defences related to bankruptcy proceedings and potential claims against the CEO, directors or creditors. However, the Criminal Code specifies a list of general defences (circumstances in which criminal liability may not be imposed). These are unlikely to apply to crimes in relation to bankruptcy.

2.7.3 *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 their 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 with the criminal liability, this is unlikely to apply to offences relating to bankruptcy.

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 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;

(b) controlling persons; and

(c) the 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 in the cases referred to in paragraphs (a) to (d) of Section 1.3.4;

(2) the members of the liquidation committee of the debtor if, in the course of a solvent liquidation, either of the tests referred to in paragraph (d) of Section 1.3.4 is met;

(3) the members of the liquidation committee (the liquidator), if in the course of a solvent liquidation it emerges that the value of the debtor's assets is insufficient to satisfy the claims of its creditors in full; and

(4) the CEO of the debtor, founder (shareholder or participant) in the course of a solvent liquidation, when the decision to liquidate the debtor has been taken, but the liquidation committee has not yet been established, and it emerges that the value of the debtor's assets is insufficient to satisfy in full the claims of its creditors.

The CEO in cases mentioned in (1) above must file for bankruptcy within one month of the relevant circumstance arising. The members of the liquidation committee in the case referred to in (2) above must file for bankruptcy within ten calendar days of either of the mentioned tests being met. No time period is specified for filing a bankruptcy petition under (3) and (4) above.

Should the persons mentioned above fail to file for bankruptcy, they may bear secondary liability for new debts arising after the date when the petition should have been filed.

3.3 Liability of controlling persons

The liability of a controlling person for the debts of the company in the case of bankruptcy of the company is envisaged by several laws and with respect to different forms of legal entities. According to the general approach of the civil legislation, controlling persons include founders (shareholders/participants), shareholders who are members of the management board or board of directors and the CEO.

While the principal focus of the Civil Code is on the founders and shareholders/participants of the debtor, the actions of members of the board of directors (both executive and non-executive directors) and the CEO also fall within the wording of the relevant provisions of the Civil Code.

The Civil Code provides that, if bankruptcy (insolvency) of a 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 can bear secondary liability for the obligations of such legal entity. The same provision is envisaged by the LLC Law.

In contrast, the JSC Law contains provisions that appear to restrict considerably the scope of potential liability borne by the controlling person of a joint stock company by adding a requirement of knowledge that bankruptcy would result. The JSC Law imposes potential liability only in those situations where such persons 'have used their right to give binding instructions with intent that the company takes an action, knowing in advance that such action would result in its bankruptcy'.

In addition to the above, under the Insolvency Law a few years ago a new concept of controlling persons and the triggers for their subsidiary liable for the debts of the company was introduced (see Section 1.3.5 and Section 2.2). Under this concept a controlling person includes a person who, within the two year period prior to the commencement of insolvency proceedings, has or had the right to give binding instructions to the debtor or otherwise is or was able to determine the debtor's actions.

The Insolvency Law expressly provides that controlling persons include (i) members of the debtor's liquidation committee; (ii) the debtor's representatives (authorised whether by virtue of a power of attorney, regulation or special authorisation) who could enter into the transactions on behalf of the debtor; and (iii) persons (entities) that had rights to dispose of 50 per cent or more of the voting shares or participatory interest, as the case may be.

The grounds for holding controlling persons liable under the Insolvency Law, the level of their liability and possible defences are described in detail in Section 1.3.5 and Section 2.2. above.

In the absence of established court practice under the new provisions of liability for controlling persons (largely due to the fact that new rules apply only if the grounds for holding controlling persons liable, e.g. giving binding instructions to the debtor, occurred after the new rules became effective) it remains unclear (i) whether these provisions are intended to capture the CEO of the debtor (there are arguments that the CEO of the debtor should fall within the scope of the definition of a controlling person) and, if the CEO is to be captured (ii) how the above provisions coincide with the general rules on holding the CEO liable under the JSC and LLC laws.

In the absence of sufficient court practice it remains unclear whether in order to establish liability against a controlling person under the new concept it needs to be proved that the performance by the debtor of the instructions given by a controlling person in fact resulted in the debtor's bankruptcy (i.e. whether the general rules provided by the Civil Code that liability may be incurred only when bankruptcy of the debtor was caused due to the fault of a controlling person are to be applied). In addition, it also remains unclear whether the liability for controlling persons when they give binding instruction to a JSC (unlike an LLC) is a knowledge test (i.e. that they knew in advance that actions of the company following such instructions would result in a JSC bankruptcy) or a more general and much wider ground for establishing liability provided by the Insolvency Law is to prevail irrespective of the legal form of the company.

3.4 Liability of the parent company

Under Russian law[20] a company which is able to determine the activities of another company (the 'subsidiary') is considered to be a parent company ('parent company') of such subsidiary. This ability to control can derive from the parent company's shareholding in the subsidiary, or 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 has been caused by its parent company, the latter can bear secondary liability for the debts of its subsidiary.

The JSC Law provides that if the bankruptcy of a subsidiary has been caused by its parent company, the latter bears secondary liability for the debts of its subsidiary only if the parent company has deliberately exercised its right (set out in the charter of the subsidiary or in the agreement with the subsidiary) or its ability to give mandatory instructions to the subsidiary knowing that its instruction will result in the bankruptcy of the subsidiary. This liability is limited to situations where the parent company has actual knowledge that bankruptcy of the subsidiary would follow.

The LLC Law contains a similar provision, that if the bankruptcy of a subsidiary was caused by its parent company, the latter bears secondary liability for the debts of the subsidiary if its assets are insufficient to pay its debts.

The Civil Code does not specify the reasons or the degree of fault sufficient to trigger the above rules. The inquiry is likely to be very fact-specific in each case.

A parent company would also qualify as the controlling person discussed 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 counterparty 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, the 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 after commencement of bankruptcy proceedings a court-appointed bankruptcy administrator[21] can challenge transactions and decisions of the debtor at any stage of bankruptcy proceedings. As a result, the general principles of the Civil Code with respect to voidable transactions and the application of consequences of void transactions (irrespective as to whether they are entered into within the 'twilight' period or outside thereof) subject to the general limitation periods apply.[22]

4.2 General principles in respect of void and voidable transactions

The Civil Code provides that a transaction can be invalid if it is either a 'void' or 'voidable' transaction. An invalid transaction does not create legal rights and obligations and as a general rule the parties are to be restored to their initial position. A void transaction is void from the moment of its inception irrespective of whether it is recognised as such by the court. In contrast, a voidable transaction can be declared invalid only by a court.

The Civil Code provides that, as a general rule, transactions inconsistent with law, entered into contrary to public policy etc, are void. Other transactions are voidable. They include transactions of legal entities made beyond their powers, fraudulent transactions, transactions entered into under duress etc.

The limitation period for void transactions is three years from the date of commencement of their performance. For voidable transactions, a claim seeking a declaration of an invalid transaction must be filed within one year from the date on which the claimant knew or should have known of the circumstances serving as grounds for invalidating the transaction. As the Insolvency Law does not provide for limitation periods, the general provisions of the Civil Code apply to such transactions.

4.3 Declaring transactions invalid under the grounds provided by the Insolvency Law

Following amendments to the Insolvency Law back in mid-2009, the following specific types of transaction can be challenged in the bankruptcy court:

(a) so called 'suspicious' transactions which include: (i) transactions at an undervalue; and (ii) transaction aimed at defrauding creditors; and

(b) preferential transactions.

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[20] Article 105 of the Civil Code.

[21] That is an interim administrator, financial rehabilitation administrator, external administrator or liquidator.

[22] Article 181 of the Civil Code.

Such transactions may be challenged only by an insolvency administrator appointed in respect of a debtor either at his own discretion or when requested so by a creditors' meeting or committee and only at the stage of external administration (if any) or liquidation.

Recoveries from a successful challenge will be clawed back and all assets disposed of by the debtor under such transactions are to be returned to the bankrupt estate (see Section 6.1).

4.3.1 *Transactions 'at an undervalue'*

These are transactions where the consideration received or to be received by a debtor is 'inadequate' (i.e. where the market value of the transferred assets is significantly higher than the consideration received or to be received taking into account the circumstances of the transaction, including where the price or other terms of such transaction are materially less favourable than those of comparable transactions concluded in comparable circumstances).

Such transactions may be challenged if entered into or performed within one year preceding, or at any time after, the opening of insolvency proceedings.

4.3.2 *Transactions aimed at defrauding creditors*

These transactions are treated as aimed at defrauding creditors if the following conditions are all satisfied:

(i) the purpose was to prejudice the property rights of creditors (such purpose is presumed, among other things, if at the time of entry into the transaction the debtor was unable to pay its debts or the liabilities of a debtor exceeded the value of its assets and (a) no consideration was paid to the debtor; or (b) the transaction was with an 'interested party'); 'interested parties' include, among others, the CEO of the debtor and its directors as well as affiliates and companies comprising the so-called 'group of entities' to which the debtor is attributable; and

(ii) such transaction was prejudicial to creditors' rights (e.g. resulted in a decrease of the value or the size of the debtor's assets or an increase in the value of claims against the debtor or other consequences that entail or could entail the inability of creditors to satisfy their claims from the debtor's assets); and

(iii) the counterparty knew or should have known of the above purpose at the time of entry into such transaction (among other things, it is presumed that the counterparty knew of such purpose if it was an 'interested party' or it knew or should have known of the signs of the debtor's inability to pay or insufficiency of the debtor's assets).

Transactions aimed at defrauding creditors may be challenged if they are entered into or performed within three years preceding, or at any time after, the opening of the insolvency proceedings.

4.3.3 *Preferential transactions*

These are transactions that result or may result in preferential satisfaction of a particular creditor over other creditors, including but not limited to one of the following transactions:

(i) granting of security or guarantees for pre-existing indebtedness;

(ii) transactions that may alter the ranking of creditors in insolvency with respect to claims which arose before the entry into such a transaction;

(iii) transactions that will or may result in the satisfaction of unmatured claims of creditors where the debtor has failed to satisfy its matured claims; or

(iv) transactions that prioritise or may prioritise the claims of a creditor which arose before the entry into such a transaction when compared to the ranking of its claims according to the statutory ranking of creditors in insolvency.

Preferential transactions may be challenged if entered into or performed within one month preceding, or at any time after, the opening of insolvency proceedings. However, preferential transactions falling simultaneously within (i) and (ii) above, or falling within any of the above where the counterparty knew of the debtor's inability to pay or that the debtor's liabilities exceeded the value of its assets, are subject to a six month hardening period. A counterparty that is an 'interested party' is presumed (unless proved otherwise) to have such knowledge.

4.4 Defences available to a counter-party to protect vulnerable transactions

The Insolvency Law specifies certain transactions that cannot be challenged:

(i) transactions concluded on an organised trading platform on the basis of a bid addressed to an unlimited number of trading members as well as acts comprising performance of such transactions cannot be challenged on any of the above grounds;

(ii) transactions entered into in the ordinary course of business if the value of assets disposed of or obligations incurred does not exceed 1 per cent of the balance sheet value of the debtor's assets; such transactions cannot be challenged as transactions at an undervalue or as preferential transactions;

(iii) transactions where the debtor received adequate consideration; however such transactions can be challenged as a transaction aimed at defrauding creditors.

QUESTION 5

5. Enforcement

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

In cases of failure to file a bankruptcy petition where such obligation is mandatory (see Section 1.3.4) and in cases where the controlling persons may be exposed to liability for giving instructions to the debtor as a result of which a harm to creditors was caused (see Section 1.3.5), an insolvency administrator appointed for the liquidation stage (at his own discretion or if requested by the decision of the creditors' meeting or creditors' committee), the registered creditors and agencies whose claims were not satisfied from the bankruptcy estate of the debtor have the right until completion of the liquidation stage of insolvency to bring an action against the relevant persons to make them liable for the relevant debts.

Further, the company itself and any of its shareholders owning a total of at least 1 per cent of the company's common shares can file a claim against a member of the board of directors.[23] When a claim seeking compensation for damages is filed against a member of the board of directors of a company, the burden of proof lies with the claimant. These rules apply to claims against the CEO, directors, members of the management board and managing company in cases where loss is caused by their actions (or inactions).

The right to initiate administrative proceedings relating to fraudulent or deliberate bankruptcy or unlawful actions during the bankruptcy vests in the Ministry of Home Affairs and, in certain circumstances, in other authorised official bodies having the right to bring administrative actions.

If a person uses their position in violation of the law and contrary to the interests of the company and the actions of such person have resulted in substantial loss to the company (and that company is not a state or municipal enterprise), the criminal proceedings[24] may be initiated only by such company.

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 transactions and restitution

As a general rule, everything recovered as a result of a transaction being successfully challenged on the grounds provided by the Insolvency Law (and referred to in Section 4.3) will be clawed back and all assets disposed of by the debtor under such transactions are to be returned to the bankrupt estate. In turn, counterparties of the debtor will have a claim against the debtor for the value of the returned property, and will generally rank pari passu with other unsecured creditors of the debtor. However, in the case of (i) preferential transactions subject to a six month hardening period; or (ii) transactions 'aimed at defrauding creditors', the counterparty's claim will in each case rank behind the claims of unsecured creditors.

6.2 Administrative fine and disqualification

The Administrative Offences Code envisages an administrative fine of up to RUR 50,000 or disqualification for up to three years as the main measure of administrative liability of the CEO, and, potentially, members of the board of directors, members of the management board etc. for offences relating to insolvency (bankruptcy).

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, management (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 that register that the candidate has not been disqualified.

As mentioned above the administrative liability measures apply to the extent the offence does not involve acts subject to criminal sanctions.

6.3 Imprisonment and fine

The Criminal Code envisages the following remedies:

(1) illegal actions during the bankruptcy – imprisonment for up to three years with or without a fine; or community works for up to 480 hours; or correctional works for up to two years; or mandatory works for up to three years; or detention for up to six months; or a fine of up to RUR 500,000 or in the amount of the wage (or other income) for a period of up to three years;

[23] Article 71, clause 4 of the JSC Law.
[24] Article 201 of the Criminal Code.

(2) deliberate bankruptcy – either a fine of up to RUR 500,000 or in the amount of the wage (or other income) for a period of up to three years; or without a fine; or imprisonment for up to six years with a fine of up to RUR 200,000.

(3) fraudulent bankruptcy – either a fine of up to RUR 300,000 or in the amount of the wage (or other income) for a period of three years; or imprisonment for up to six years with a fine of up to RUR 200,000 or in the amount of the wage (or other income) for a period of up to 18 months or without a fine.

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 imposes an express duty on the CEO to disclose information to the bankruptcy administrator appointed by a bankruptcy court at the first stage of insolvency (supervision) where the CEO remains in place but with limited powers, and at the liquidation stage. In particular, within 15 days after the appointment of a bankruptcy administrator in the course of a supervision stage, the CEO must provide the bankruptcy administrator and a bankruptcy court with the list of all the debtor's assets and make available the accounting and other documents reflecting business operations of the debtor for the period of three years prior to the commencement of the supervision stage of insolvency.[25] In addition, on a monthly basis the CEO must inform the bankruptcy administrator of any changes in the debtor's assets.

Similarly, at a liquidation stage the CEO and previous bankruptcy administrators must procure, within three days of the appointment of the liquidation administrator, that the latter is provided with the accounting and other documents with respect to the debtor.[26]

As regards other insolvency stages (financial recovery and external administration), there is no general obligation on the CEO to provide any information or otherwise co-operate with an investigation into the company's affairs following its insolvency. However, there are several provisions that entitle the bankruptcy administrators to obtain information from the debtor in respect of its business activities and upon request the debtor's management bodies are to provide the bankruptcy administrator with all information concerning the debtor's activity.

At the initial stages of bankruptcy, such as supervision and financial recovery, the appointment of the bankruptcy administrator does not constitute grounds for the CEO's dismissal or termination of the powers of other management bodies of the debtor. They continue to exercise their powers subject to the limitations established by the Insolvency Law. Therefore, the duty to co-operate with the bankruptcy administrator may be inferred from a number of provisions of the Insolvency Law. At the later stages of external management and liquidation, the bankruptcy administrator replaces all other governing bodies of the debtor. At this stage, the co-operation of the CEO becomes to a considerable extent obsolete and therefore, at the liquidation stage, the CEO, along with the previously appointed bankruptcy administrator, are obliged to provide all necessary financial and other documentation to the liquidation administrator.

In mid-2009 the Insolvency Law was amended by adding provisions which introduced personal secondary liability of the CEO for the obligations of the debtor in case the accounting or other reporting documentation of the debtor that is required to be maintained by Russian law proves to be missing, or the relevant information on the assets and liabilities of the debtor and their flows proves to be incomplete or untrue, in each case as of the date of instigation of the supervision stage or declaration of the debtor's bankruptcy.

As mentioned earlier illegal actions during the bankruptcy (including nondisclosure of information about the property or reports on the activities of the company) are also subject to either administrative or criminal liability.

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 Mandatory filing and the liability of the CEO and controlling persons

Actions against directors in connection with failure to file a bankruptcy petition when such filing is mandatory and in connection with liability of controlling persons where instructions given by such persons and performed by the debtor resulted in harm to creditors may be brought until the completion of the liquidation stage of the insolvency proceedings of the debtor. It appears that no other additional limitation periods would apply in this case.

[25] Article 64(3.2) of the Insolvency Law.
[26] Article 126(2) of the Insolvency Law.

8.2 Challenging transactions vulnerable in insolvency

The limitation period for challenging transactions under grounds envisaged by the Insolvency Law and triggered by the instigation of insolvency proceedings is one year. It starts running from the time when the relevant bankruptcy administrator knew or should have known about the grounds for challenging the transactions provided for in the Insolvency Law.

8.3 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 ten 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 an authorised person which issued the decision. Within three days these persons should direct such appeal together with the matter file to the competent court, higher official body or an authorised person[27] that occupies a more senior position. Alternatively, the appeal may be submitted directly to the court, or official body or the authorised person. An appeal should be considered within ten days from the date of submission.

8.4 Criminal offences

The Criminal Code envisages the following limitation periods:[28]

(1) two years after the commission of a petty crime;

(2) six years after the commission of a moderately grave crime;

(3) ten years after the commission of a grave crime;

(4) fifteen years after the commission of an especially grave crime.

Under Russian criminal legislation illegal actions during the bankruptcy are considered petty crimes and therefore the limitation period in respect of such crimes is two years. Deliberate and fraudulent bankruptcy constitute grave crimes, and the limitation period for the commitment of such crimes is ten years.

As a general rule, the limitation period is calculated from the day the crime is committed.

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?

The Insolvency Law applies to all commercial legal entities that may be declared insolvent under Russian law. Provisions of the Insolvency Law do not apply to state corporations (gosudarstvennaya korporatsiya).

The Insolvency Law also states that the relations involving foreign 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.

The Insolvency Law does not expressly provide that it applies to Russian legal entities, but as a practical matter the application of the procedures outlined above to foreign entities could be problematic, and Russian bankruptcy courts are likely to decline to assert their jurisdiction over such entities in bankruptcy matters.

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?

Neither the Insolvency Law nor any other legislation provide for an obligation to insure the directors' liabilities in the case of bankruptcy. However the companies legislation and the Insolvency Law gives rise to a potential liability in respect of the CEO, members of the board of directors and the management board for certain damages.[29] Therefore, as with any other legal liability risk, such risk can be insured.

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[27] Article 30.2 of the Administrative Offences Code.
[28] Article 78 of the Criminal Code.
[29] Article 71 of the JSC Law and Article 44 of the LLC Law and Article 10 of the Insolvency Law.

The insurance contract can be concluded by the company itself; it is not possible as a matter of practice to enter into an insurance contract by an individual who is the CEO, member of the board of directors or member of the management board of the company. There are arguments (driven mostly by tax reasons) that the director whose liability is insured by the company should be named in the insurance contract between such company and the insurer.

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 the performance of their official duties;

(3) violation of conditions relating to the powers of directors envisaged by law.

As a general rule, the insurance policy may provide for the following compensation:

(a) compensation in respect of damages awarded by a court decision;

(b) compensation in respect of damages agreed in an out-of-court settlement;

(c) compensation in respect of necessary and reasonable expenses to conduct the defence.

Losses caused to a company by the CEO, members of the board of directors or the management board are reimbursed by the insurance company within the limits specified in the insurance contract. If the insurance compensation is insufficient to cover all losses caused to a company, such a director will be responsible for the shortfall.[30]

Programmes insuring the liability risk of management bodies of commercial entities are offered in Russia by a number of insurance companies. It is not possible to get insurance to cover criminal prosecution or criminal liability in Russia.

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 specific provisions with respect to incurring further credit by an insolvent company. An unconnected third party may rely on the validity of transactions entered into with an insolvent company subject to the general provisions discussed above.

[30] Article 1072 of the Civil Code.

SPAIN

OVERVIEW

The Spanish insolvency Act (the Insolvency Act) 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.

(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. Under the old legislation, 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 arm's length and for good commercial reasons 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 receivership 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

(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 (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.

On 31 March 2009, the Insolvency Act was subject to reform under Royal Decree-Law 3/2009, of 27 March. The main changes are:

(a) the protection from the Rescission Regime (see 1.1.1 below) of restructuring agreements entered into by the insolvent company prior to the filing for insolvency provided certain requirements are met; and

(b) the ability for an insolvent company to initiate a negotiation period in order to obtain agreement to an Advanced Settlement Proposal prior to an actual filing for insolvency and thereby delay the insolvency filing. (Refer to the Appendix for further information about the Spanish single insolvency procedure and, in particular, the Settlement phase and the procedure for obtaining approval of Settlements.)

The reform also includes the clarification of certain issues that were debated amongst scholars and the reform of articles of the Insolvency Act regarding notification of the events of the Insolvency.

[1] The old Spanish general insolvency regime was set out mainly in:
(a) the Spanish Commercial Code of 1885 (*Codigo 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 Suspension de Pagos*). 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.

In January 2012, the Insolvency Act was subject to further reform under Law 38/2011 of 10 October. The main amendments to the Insolvency Act are:

(a) To provide alternatives to filing for insolvency.

(b) Enhanced protection of refinancing agreements. There are two different kinds of moratorium that might be requested in relation with a refinancing agreement:

- A short one month moratorium that affects all kinds of creditors and stays any foreclosure actions while the endorsement of the enforcement is being decided.
- A moratorium of up to 3 years that affects only financial creditors that do not have in rem guarantees.

(a) Favourable treatment of new monies obtained by means of a refinancing agreement or during the insolvency proceeding.

(b) A single Receiver instead of various receivers, and more detail on the Receivers functions and profile. Possible appointment of corporates to act as Receiver.

(c) Amendments in the abbreviated proceeding in order to make it more agile.

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 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 (that is, when it ceased generally paying debts). All transactions completed during that period, even if at arm's 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 provided they were not performed in the context of a "restructuring agreement" (as set out in the Royal Decree-Law 3/2009 – see further 4.1.2 below).

1.2 Rescission claim under the Civil Code

(a) In addition to the Rescission Regime, any unsatisfied creditor may claim rescission of certain contractual or commercial operations on the basis of a fraud on creditors (accion 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.

(b) The Receiver is also entitled to bring an action in relation to transactions performed by the debtor beyond the two-year "twilight" period referred to above.

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?

There are no special provisions giving rise to liability of company directors during the "twilight" period. Rather, any director may be held liable if any action carried out during the "twilight" period would give rise to liability according to corporate, insolvency and criminal law as stated below. There is therefore no difference between the liability regime during and outside the "twilight" period.

2.1 Liability under corporate law

2.1.1 *Actions giving rise to Directors' liability*

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 law;

(b) contrary to the company's by-laws; or

(c) carried out in breach of directors' duties to the company.

Directors' liability is established in Article 236 of the Spanish Companies Act (Ley de Sociedades de Capital), (LSC)

2.1.2 *Liability of de facto directors*

Corporate directors' duties and liabilities do apply to *de facto* directors (those who are not formally appointed as directors but have acted *de facto* as if they were directors of a company).

2.1.3 *Corporate duties of company directors*

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 225 and 226 LSC).

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.

The specific duties for directors included in the Spanish Companies Act are:

(a) Duty of loyalty

Under the LSC, the former duty of fidelity has been merged with the duty of loyalty.

The duty of loyalty was introduced by Law 26/2003 aimed at avoiding conflicts of interest between directors and the company and also at impeding directors from carrying out unauthorised competing activities.

The duty of loyalty requires that:

(i) directors 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 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 the conflict. Information on conflicts of interest between the company and its directors should be included in the annual report on corporate governance; and

(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) as 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.

(b) Duty of confidentiality

Even after their appointment has ceased, directors 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. The duty described shall not apply to cases in which, pursuant to the legislation, such information may be conveyed to third parties or if it is required by or must be sent to the respective legal supervisory authorities.

2.1.4 *Available courses of action*

The Spanish Companies Act provides for the following actions for breach of directors' duties:

(a) Corporate action (acción social):

This action is aimed at protecting and recovering company's assets damaged by directors' actions.

The company itself through an agreement of the shareholders' meeting may file a corporate action against its directors. Shareholders with at least five per cent stake in the share capital of the company may also: (i) require the shareholders' meeting to be called with the purpose of approving a corporate action; and (ii) file a corporate action if the requested shareholders' meeting is not called or if the decision of the shareholders is not to file a corporate action.

Creditors also have legal standing to file a corporate action if it is not filed by the company or the shareholders, if and to the extent company assets are not enough to repay credits.

There is a four-year limitation period, which starts running from the removal/dismissal of the responsible director(s).

Nevertheless, in relation to bona fide claimant this limitation period should be counted as from the registration of the removal/dismissal at the Commercial Registry (Supreme Court Decision 11 November 2010).

(b) Individual action (acción individual):

This action is aimed at protecting and recovering the personal assets of the claimant to the extent that it has suffered personal damages as a consequence of any directors' action or omission giving rise to liability.

Only shareholders personally affected by directors' actions or omissions and creditors have legal standing to file an individual action against corporate directors.

There is a four-year limitation period, which starts running from the removal/dismissal of the responsible director(s). In relation to bona fide claimants, this limitation period should compute from the registration of the removal/dismissal registration at the Commercial Registry (Supreme Court Decision 11 November 2010).

2.1.5 *Type of liability and limitation*

The liability of the directors is joint and several. 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 of the company.

Likewise, directors' legal liability cannot be modified contractually, unless a more strict liability is agreed and, therefore, any corporate document or corporate arrangement aimed at limiting the director's liability is invalid.

However, a director will not be liable for the acts of other directors where the relevant director can demonstrate that:

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

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.

Therefore, the general defences available to directors are:

(a) the director's behaviour was not negligent; he/she did not breach any law, regulation, the by-laws or his/her duties as a director of the company; and

(b) 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 a damaging event.

2.1.6 *Special (direct and objective) liability in cases of capital impairment*

In cases of capital impairment (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 company's debts incurred as at the date the directors were aware or should have been aware of the capital impairment situation (Article 367 of LSC).

This liability is direct and objective in the sense that no damages have to be proven. In comparison, the corporate action and the individual action mentioned above require the claimant to prove actual damages.

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 from the date they were aware or should have been aware of the capital impairment situation; 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 declaring the winding-up or the insolvency, as the case may be; or (ii) within two months of the proposed date for the general shareholders' meeting, if it was not held.

[2] The subscribed capital to net equity ratio will be 2:1.

The Spanish courts have established that complying with the requirement in former Article 367 LSC to convene a meeting to wind-up the company does not relieve the directors of potential liabilities under the Insolvency Act if the company was insolvent at the time of the winding-up. (Appeal Court Decision –Audiencia Provincial – of Valencia of 10 March 2008).

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, (ii) when the liquidation phase is commenced and (iii) when the company fails to comply with the settlement agreement. (For further information on the qualification and other phases in the insolvency proceedings process, refer to the Appendix to this chapter.)

2.2.1 *Liability under Article 172 of the Insolvency Act*

The Commercial Court may declare the company's directors and liquidators (whether formally appointed or in the shadows) provided they occupied that position at any time during the last two years prior to the declaration of insolvency) liable when:

(i) the "qualification" section of the insolvency has been opened; 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.

In particular, an insolvency would be classified as guilty if:

(a) the company has failed substantially in its obligation to maintain proper accounts, or has committed an irregularity pertinent to a person's understanding of the company's financial situation or assets;

(b) the company has filed false or misleading documents in support of the application for the declaration of insolvency or during the course of insolvency proceedings[3];

(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 likely to be 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.

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. Alternatively, within this two month period, the company has the option of notifying the court that it has initiated negotiations for reaching a refinancing agreement or for obtaining the necessary support to an Advanced Settlement Proposal. In this case, the company will be given three months to close the refinancing agreement or to obtain the support for the Settlement Proposal. Otherwise, once the three month period has expired, the company will have one additional month to file for insolvency;[4]

(b) have failed in their duty to co-operate 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.

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.

 Upon the request of the insolvency administrator the court may authorise the disqualified director to continue managing the company to facilitate the settlement agreement with creditors;

(b) the removal of the rights of any person affected by the qualification (including any person found to have contributed towards the insolvency) as creditors of the company;

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[3] The Spanish courts have established that the misleading or false document or fact must be relevant to the comprehension of the situation of the company. (Sentence of the Commercial Court of Asturias of 29 October 2007.)

[4] As established by the Royal Decree-Law 3/2009.

(c) that any rights or assets of such persons, that may have been unduly obtained from the assets of the company or received from the pool of assets, be returned; and

(d) that any loss or damage caused be indemnified.

2.2.2 *Patrimonial Liability under Article 172 bis.1 of the Insolvency Act*

Provided the "qualification" section is open as a result of the winding-up of the insolvent company, directors and liquidators (whether formally appointed or in the shadows) and general managers may be held liable for any deficit in the amount available to pay to creditors (that is, 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.

2.2.3 *Interaction between liability under corporate law and under insolvency law*

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 the Insolvency Act could extend both to damages caused to the company and to debts (deficit) which the liquidation of the company cannot cover.

Whilst there is no legal basis for saying that the liability under the Insolvency Act should prevail over the directors' liability under the Spanish company law, it is 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 by the company or to creditors who have directly suffered loss themselves.

While the insolvency is running, creditors will be prevented from bringing any claims against directors based on breach of obligations relating to the winding up of the company. This limitation does not extend to claims against directors based on damages derived from individual wrongdoings. 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.

2.3 Liability under criminal law

2.3.1 *Corporate's liability*

Since the amendment to the Spanish criminal code under Act 5/2010 entered into force on 24 December 2010, not only individuals but also companies can be held criminally liable for certain offences – which include insolvency offences. In other words the amendment left without effect the so-called latin principle "societas delinquere non potest" (ie companies cannot commit crimes).

The system of corporate criminally liability provided for by the Reform is based on new Article 31 bis of the Spanish Criminal Code. This Article establishes that a company can be held criminally liable for certain criminal offences committed (on behalf of them and for their benefit) by (i) persons holding powers to represent them, or by their *de facto* or de jure directors, and (ii) by persons subject to the control of managers and directors, if the crime ensues from a violation of their supervisory and control obligations.

The criminal liability of a company may arise even if no liability has been established on the part of a director or legal representative. This is to say that the company is not precluded from being held liable if a specific individual responsible for the criminal offence has not been identified or has escaped justice.

Fines are established as the ordinary consequence of any criminal behaviour committed by companies. However, usually for cases of significance, the courts may impose punishments such as winding-up, suspension of trading, prohibition from engaging in activities related to the unlawful act, the closing of offices or establishments, confiscation, prevention from obtaining public subsidies, public incentives tax or social security benefits.

Likewise, the Organic Law 5/2010 recognises the possibility that the penalty of winding-up may be extended to a company which, despite not having carried out the offence, continued the economic activity of the wound-up company and maintained its identity of clients, employees and suppliers.

2.3.2 *Director's liability*

Besides the criminal liability of corporations, the Spanish Criminal Code provides for individuals who carry out a criminal act (be it by action or omission) in the name and on behalf of a legal entity (i.e. directors or legal representatives of a company or any other individual with managerial duties) to be criminally liable where the felony/misdemeanour has been committed (and the conditions of the felony satisfied) in the name of the legal entity in whose name or on behalf of whom they so act (even if that individual does not himself fulfil the conditions or qualities required by the relevant felony/misdemeanour). However, not all directors or representatives in office when the offence is committed will be criminally liable. Knowledge and intent (or gross negligence for certain crimes) are essential. Likewise, omissions may give rise to criminal liability when the director breaches his/her duty of care vis-à-vis the company's so that the wrongful result materialises as if s/he had actively caused it.

The voluntary or compulsory removal of a director does not exempt him/her from criminal liability arising as a result of past conduct. New directors of a company that has committed criminal offences in the past (through previous directors, legal representatives or managers) are not liable for past criminal offences, though newly appointed directors helping former directors to conceal their crime from the authorities or to enjoy the proceeds their crime may commit several different offences (covering up, money laundering, etc.).

2.3.3 *Insolvency and corporate offences under the Spanish Criminal Code:*

(a) Crimes committable by both natural and legal persons (insolvency offences):

- Concealment of assets ("alzamiento de bienes"): This offence arises when any person, 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.

- Post-insolvency concealment and favouring creditors: 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 the authorisation of the court or the insolvency administrators.

- Guilty punishable insolvency: This offence arises when the insolvency of the company was caused or aggravated on purpose by the company or persons acting on behalf of the company.

- Inaccuracy of accounting documents: This offence arises if any person files documents in the insolvency proceedings which knowingly provide inaccurate data on the company's financial situation with the aim of improperly obtaining a declaration of insolvency.

(b) Crimes committable only by natural persons (corporate offences):

- Forging corporate documents: 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.

- Abusive resolutions: Any person who, by exercising 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.

- Harmful resolutions: Any person who harms the company or any of its shareholders by imposing a resolution that has been adopted by fraudulent means (eg 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).

- Violation of shareholders' rights: Any director (whether formally appointed or de facto) who prevents shareholders from exercising their political rights (eg right to information, right to take part in the running of the company, etc).

- Breach of obligation to cooperate with any relevant authority: 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.

- legal disposition or illegal contracting: 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).

2.3.4 *Penalties attached to the above criminal offences:*

(a) For natural persons:

- Concealment of assets: imprisonment for one to four years and a fine based on a period of 12 to 24 months; however, if the debts evaded were public (ie, if the creditor was a Public Administration or entity, such as the Treasury), imprisonment will be up to six years. Imprisonment will range from two and a half to four years (six in the case of public debts) and a fine based on a period from 18 to 24 months if one or several of the following aggravating circumstances were met: the concealment affects belongings of prime necessity, dwellings or other assets of recognised social utility, or the concealment is especially serious in view of the magnitude of the damage and the financial situation in which it leaves the victim or his family; or when the amount of what is concealed exceeds 50,000 euros.

- Post-insolvency concealment and favouring creditors: imprisonment for one to four years and a fine based on a period of 12 to 24 months.

- Guilty insolvency: imprisonment for two to six years and a fine based on a period of eight 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.

- Inaccuracy of accounting documents: imprisonment for one to two years and a fine based on a period of six to 12 months.

- Forging corporate documents: imprisonment for one to three years and a fine based on a period of six to 12 months.

- Abusive resolutions: imprisonment for between six months and three years or a fine of up to three times the profit obtained.

- Harmful resolutions: imprisonment for between six months and three years or a fine of up to three times the profit obtained.

- Violation of shareholders' rights: a fine based on a period of six to 12 months.

- 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.

- Illegal disposal or illegal contracting: imprisonment for between six months and four years and a fine of up to three times the profit obtained.

When imposing a penalty, the general rule is that the court must have regard to the degree of participation by the individual in the criminal offence (that is, whether they were the perpetrator, an accomplice or were otherwise profiting from the crime). Consequently, the extent of the specific involvement of a director would be relevant to the sanction imposed.

(b) For legal persons:

- Fine from two to five years, if the offence committed by a natural person is punishable by imprisonment exceeding a period of five years.

- Fine from one to three years, if the offence committed by a natural person is punishable by imprisonment exceeding a period of two years.

- Fine of six months to two years, in the rest of the cases.

- If the judge deems it suitable, in accordance with the general aggravating circumstances set out in the Criminal Code and to the established extent, the following complementary penalties may be imposed on companies found criminally accountable:

  – Dissolution of the legal person. The dissolution shall cause definitive loss of its legal personality, as well as of its capacity to act in any way in legal transactions, or to carry out any kind of activity, even if lawful.

  – Suspension of its activities for a term that may exceed five years.

  – Closure of its premises and establishments for a term that may not exceed five years.

  – Prohibition from carrying out the activities through which it has committed, favoured or concealed the felony. Such prohibition may be temporary or definitive. If temporary, the term may not exceed 15 years.

  – Barring from obtaining public subsidies and aid, from entering into contracts with the public sector and enjoying tax or Social Security benefits and incentives, for a term that may not exceed 15 years.

  – Judicial intervention to safeguard the rights of the workers or creditors for a period deemed necessary, which may not exceed five years. The intervention may affect the whole of the organisation or may be limited to some of its premises, sections or business units. The Judge or Court of Law shall determine exactly, (in the sentence, or subsequently by ruling) the content of the intervention and shall determine who shall take charge of the intervention and how often monitoring reports must be submitted to the judicial body. The intervention may be amended or suspended at any time, following a report by the receiver and the Public Prosecutor. The receiver shall be entitled to access all the installations and premises of the company or legal person and to receive as much information as he may deem necessary to exercise his duties. The implementing regulations shall determine the aspects related to the exercise of the duties of the receiver, as well as his remuneration or necessary qualifications. Temporary closure of premises or establishments, suspension of corporate activities and judicial intervention may also be agreed by the Investigating Judge as a precautionary measure during the investigation of the case.

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?

There are no special provisions giving rise to liability of other persons involved in the company's affairs during the "twilight" period. Rather, any other person may be held liable if any action carried out during the "twilight" period would give rise to liability as discussed in Sections 2.1, 2.2 and 2.3 above. There is therefore no difference between the liability regime during and outside the "twilight" period for other persons not involved in the company's affairs.

3.1 Managers' liability

Managers are not personally liable to third parties for 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, its partners or shareholders and creditors may claim damages from a manager that acts negligently or in breach of his or her duties to the company.

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) (that is, 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.

According to Article 1903 of 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.

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 Rescission regime

4.1.1 Transactions that prejudice the pool of assets of the company, whether or not there was an intention to defraud[5], 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 (that is, transactions for no consideration or no material consideration) are presumed to be prejudicial (iuris et de iure presumption);

(b) the same irrebuttable presumption of prejudice applies to debts maturing after the insolvency is declared but which are discharged prior to then, except if such debts enjoyed an in rem guarantee in which case the presumption would be rebuttable.

(c) a rebuttable (iuris tantum) 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 The Royal Decree-law 3/2009 has established that 'restructuring' agreements may not be rescinded[6] provided they are part of a viability plan which warrants the continuation of the company in the short to medium term and which provides for either a substantial increase in the disposable credit/loans available to the company or which modifies the payment obligations of the company (or other similar modification) and provided they meet the following requirements:

(a) the restructuring agreement is signed by creditors that amount to, at least, three-fifths (60 per cent) of the total debts of the company at the time of the restructuring;

(b) the restructuring agreement has been analysed by an independent expert appointed by the Commercial Registry; and,

(c) the restructuring agreement is documented in a Spanish notarial deed.

The new Law 38/2011 also introduced a judicial endorsement regime which is available to agreements that meet the above mentioned requirements and, in addition, have the support of 75 per cent of the debt held by financial creditors.

5 According to the ruling of the Commercial Court of Madrid no. 1 of 21 May 2007, the fact that both companies knew, at the time of signing the rescinded transaction, that the company was in an insolvency situation can be sufficient evidence of bad faith in the negotiation of the transaction, therefore giving rise only to a subordinated claim in the event of rescission.

6 One of the issues which had created uncertainty previously was the potential to rescind refinancing or restructuring agreements entered into during the two-year period under the Rescission Regime (ie during the two-year period prior to filing for insolvency).

The court endorsement permits the [moratorium] established in the refinancing agreement (up to a maximum of three years) to be extended to dissenting financial creditors. While the endorsement decision is pending, the debtor may request and obtain the freezing of all enforcement actions for a limited period of time.

4.1.3 *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 (for the vast majority) remain liabilities of the company (Debts of the Company).

Debts of the Pool of Assets either originate in the insolvency proceedings (that is, 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 on their respective maturity date (except salary claims in respect of the last 30 days of work which, up to a maximum of two times the statutory minimum wage, are payable immediately) provided that the available assets of the company are sufficient to cover all these claims. Otherwise the Insolvency Act establishes the order in which the Debts of the Pool of Assets are to be paid. In any case the Debts of the Pool of Assets are always paid in preference to all Debts of the Company (other than secured claims to the extent they are covered by the secured asset).

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 (Codigo Civil), any unsatisfied creditor may claim rescission of certain contractual or commercial operations on the basis of a fraud on creditors (actio pauliana or 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 irrebuttable presumption of prejudice in the case of:*

(a) gratuitous transactions. To avoid this presumption, the counterparty should ensure that the company obtains some benefit from the transaction; and

(b) payment obligations maturing after the date that insolvency is declared but which are discharged prior to that date, except if such debts enjoyed an in rem guarantee in which case the presumption would be rebuttable. To avoid this presumption, the counterparty 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 rebuttable 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 counterparty should ensure that it is not a related entity for the purposes of the Insolvency Act, namely:

(i) a shareholder holding at least ten per cent of the share capital of the company (or five per cent 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 and/or a shareholder of such a company; and

(iv) a rebuttable presumption 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[7]. 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.

[7] Save for security granted in the context of a restructuring agreement discussed in 4.1.2 above.

4.3.5 Finally, specific actions (acciones de reintegration) 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

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) Corporate action (acción social):

The company itself, through an agreement of the shareholders meeting, may file a corporate action against its directors.

Shareholders with at least a five per cent stake in the share capital of the company may also: (i) require a shareholders' meeting to be called for the purpose of approving a corporate action; and (ii) file a corporate action if the requested shareholders' meeting is not called or if the decision of the shareholders is not to file a corporate action.

Creditors also have legal standing to file a corporate action if it is not filed by the company or the shareholders, if and to the extent companies' assets are not enough to repay their credits.

(b) Individual action (acción individual):

Only shareholders personally affected by directors' actions or omissions and creditors have legal standing to file an individual action against corporate directors.

5.2 Actions under the Spanish Criminal Code

According to Spanish statutory provisions, the public prosecutor does not have a monopoly on prosecution. The right to prosecute is also attributed to the victim.

The investigating judge always has the final say as to whether to open criminal proceedings to investigate an offence. In every case where the facts constitute a crime and there is a probable cause that an offence has been committed, the criminal procedure has to be opened in order to carry out a thorough investigation. The notitia criminis reaches the investigating judge through several channels:

(a) Through the report (denuncia) of a citizen before the police, the public prosecutor or the criminal courts of the facts that, prima facie, there appears to be an offence. As a general rule, the person reporting can be any individual who has witnessed the facts or has known them in another way. However the corporate offences referred to above may only be prosecuted when reported by the person offended or his legal representative. When the former is a minor, an incapacitated or a handicapped person, it may also be reported by the Public Prosecutor. Nevertheless, this report shall not be necessary when commission of the offence affects general interests or multiple persons.

(b) Through a formal complaint/accusatory pleadings (querella) before the criminal courts. With it, the party who files the complaint not only gives the judge information about some facts that have the appearance of a crime but also expresses his will to constitute himself as an accusing party in the process.

(c) Through the judge's direct knowledge of 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?

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 an order condemning the directors and others, which is dealt by the judge in charge of the insolvency during the qualification phase of the proceedings. This remedy within the Insolvency Act will only be available if the "qualification" section is opened.

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 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 (for example 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 Receiver 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 rebuttable 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 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[8] (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:

(a) to enter and search the domicile of the company;

(b) to monitor the communications of the company (that is, 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 delay 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

For both the corporate action (accion social) and the individual action (accion individual), there is a four-year limitation period to be counted from the removal/dismissal of the responsible director(s).

In relation to a bona fide claimant this limitation period should be counted from the registration of the removal/dismissal at the Commercial Registry (Supreme Court Decision 11 November 2010).

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] Organic laws (*Leyes Organicas*) 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.

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 casacion) before the Spanish Supreme Court if certain requirements are met such as the amount of the claim is over 600,000.00 euros and the appeal has a "cassational" interest (interes casacional).

QUESTION 9

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 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 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" (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 always 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.

9.2.4 The European Court of Justice's (ECJ) decision in Eurofood contains some guidance as to how a company's COMI is to be assessed. The ECJ held that the location of a company's registered office is key to determining its COMI. The presumption that the company's COMI is the location of its registered office can only be rebutted if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from the conclusion to which the registered office presumption would lead. Where a company carries on its business in the territory of the Member State where its registered office is situate, the mere fact that its economic choices are or can be controlled by a parent company in another Member State is not enough to rebut the registered office presumption. However, notwithstanding the Eurofood decision, ECJ guidance is still needed on what "interests" encompasses and which "interests" have greatest weight when seeking to rebut the registered office presumption.

9.2.5 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 purpose of the COMI presumption.

9.2.6 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.

9.2.7 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[9]; and

(j) rights to set-aside transactions. Specific actions (acciones de reintegration)[10] that are aimed at rescinding transactions negatively affecting the company's assets cannot be brought by 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. "Establishment" is defined as any place of operation where the company carries out a non-interim activity with human means and goods.

9.2.9 Secondary Insolvency Proceedings are governed by the same rules as Main Insolvency Proceedings; however, they 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 cases that fall outside the scope of the EU Regulation (that is, where the company is one of the corporate entities excluded from its application[11] or has its COMI 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 maximise 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.

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 themselves 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.

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[9] 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.

[10] 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.

[11] 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.

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

(v) 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 (for example, 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 irrebuttable 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.

11.5 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?

Under Spanish law, a distinction is made between a personal guarantee (payment undertakings) and an in rem guarantee (that is, 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 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 irrebuttable 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.

Also, it must be noted that where the grant of new securities or guarantees forms part of a restructuring agreement with the requisites established in 4.1.2 such guarantees or securities will not be rescindable.

(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 (that is, 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.

(a) 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 (that is, Debts of the Company) for the unsecured portion 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 on-going enforcement proceedings for the duration of the Suspension Period unless there is an express declaration by the Commercial Court stating that 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

1.1 Requirement to obtain the insolvency declaration

Under the Insolvency Act a debtor is considered legally insolvent when it cannot 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 (that is 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

(c) “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 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, compensation 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 have 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.

There is now also the option for the insolvent debtor to notify the court that it is entering into negotiations in order to obtain support to an Advanced (anticipated) Settlement Proposal (refer to paragraph 1.4 below) within the two month period for filing for insolvency. In this event, the court will grant the insolvent debtor an additional three month period to obtain sufficient support, following which the debtor company will have a month to file for insolvency. The initiation of this negotiation period prevents creditors of the insolvent debtor from filing for necessary insolvency during the three month period granted to seek support for a Settlement Proposal.

2. Insolvency proceedings

2.1 Background

The 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 (liability section of the proceedings).

2.2 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

(ii) 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 Insolvency Act, there will generally be one Receiver who might be:

- a lawyer with, at least, five years' effective experience;
- a chartered accountant with, at least, five years' effective experience; and
- a receivership company which employs this sort of professionals.

In complex proceedings a creditor with an important ordinary or preferential claim (but not a secured claim) might be appointed to act as a second Receiver.

(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.

2.3 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 Receiver (the Report of the Receiver) 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 Receiver; and

(c) the granting of a certain time period so that the list of assets or the list of the creditors can be challenged:

(i) within the ten days following receipt of the Report of the Receiver;

(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 side proceeding 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 ten days following notice of the decision admitting the claim;

(C) the eventual 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.

2.4 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 per cent of the amount of each debt, and/or subject to a delay in excess of five 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 ranking 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 Receiver, 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 after the final date for creditors to give notice of their claims and the end of the Common phase; or

(ii) between the opening of the Settlement Phase (which takes place after the approval by the court of the definitive list of creditors and inventory included in 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 consisting of votes of creditors holding at least half of the ordinary claims. 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 per cent, a simple majority of ordinary debts will be sufficient to approve the Settlement (larger percentage of ordinary claims which are held by creditors voting in favour than the percentage held by creditors expressly opposing 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 (that is termination) of the Settlement and the insolvency proceedings will be reopened to liquidate the company.

(e) *Advanced Settlement Proposal*

In addition, the debtor is entitled to file advanced/anticipated Settlement proposals (each, an Advanced Settlement Proposal) along with the filing of the voluntary insolvency petition and at any time until the expiry of the period in which creditors can give notice of their claims. An Advanced Settlement Proposal can only be filed if the debtor has not:

(i) been found guilty by definitive ruling of an economic crime; and

(ii) breached its obligation to deposit its annual accounts during the last three financial years.

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.

An Advanced Settlement Proposal needs only the support of creditors holding ten per cent of the claims in order to be admitted, provided it is filed at the same time as the filing for insolvency. Otherwise the support required for the admission would be 20 per cent.

2.5 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.

2.6 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

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, 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 an entity's 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 43 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 44 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 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 one means of demonstrating that a corporation is insolvent is by showing that it is "unable to pay its debts as they fall due in the usual course of business." *Id.* at 417. That said, whether an entity is insolvent is ultimately a question of fact which may be proved, depending on the circumstances, using various methodologies. See generally *Blackmore Partners, L.P. v. Link Energy, LLC*, 2005 WL 2709639, at *3 (Del. Ch. Ct. Oct. 14, 2005) (concluding, in the summary judgment context, that the defendant was insolvent, because the only evidence on summary judgment demonstrated insolvency under each of three tests: the balance sheet test, the equity test, and a third, "unreasonably small capital" test, under which a company is insolvent unless it can either (1) successfully issue new equity; or (2) restructure existing debt).

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 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?

A. The Trust Fund Doctrine; Director fiduciary duties in the vicinity of insolvency and the Business Judgment 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 judgment 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. 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 Judgment Rule

A majority of jurisdictions, including Delaware, provide corporate directors with a safe harbour known as the business judgment 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 judgment 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 judgment 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 judgment 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 judgment 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 judgment 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 judgment 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 judgment 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 recent decades, there has been substantial confusion over the obligations, duties, and liabilities for directors of corporations in "the vicinity of insolvency." This uncertainty traces itself back to the Chancery Court's decision 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".

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.

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 judgment 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 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.

More recently, in *National American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 290 A.2d 92 (De. 2007), the Delaware Supreme Court clarified the rights that corporate creditors have against corporations which are insolvent. Under Gheewalla, creditors have no direct fiduciary duty claims against a corporation, regardless of the solvency of that entity. However, when a corporation is insolvent, creditors effectively stand in the shoes of the shareholders, and thus may maintain derivative claims on behalf of the corporation against the directors for breach of fiduciary duty. Ghewalla did not address whether that same right to bring derivative claims also exist for creditors of corporations which are solvent but in the "zone" or "vicinity" 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, Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm, 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. See generally Douglas G. Baird and M. Todd Henderson, Other People's Money, 60 Stanford L. Rev. 1309, 1325-26 (March 2008) (discussing the distinction and tension between the default rights of creditors and the obligations of a corporate board to the corporation's shareholders).

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 judgment 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. § 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) In re *Healthco Intern., Inc.*, 208 B.R. 288 (Bankr. D. Mass. 1997) – Another example.

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.*

- 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 judgment 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 judgment 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 judgment rule is that the director has adequately informed themselves 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 judgment 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 44 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 guarantee of the obligations of the parent or an affiliate; and;

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.

(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 corporations 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 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 *Crowthers 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 obviously 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. § 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); *Gadoury 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. § 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. § 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. § 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. §§ 4001-4682) and collections on gambling winnings (see 26 U.S.C. § 3402(q)), interest and dividend payments subject to backup withholding (see 26 U.S.C. § 3406)), distribution from retirement plans (see 26 U.S.C.A. § 3405(e)), payments of interest and dividends to non-resident aliens and foreign corporations (see 26 U.S.C. §§ 1441-42), and disposition of United States real property interest by foreign persons (see 26 U.S.C. § 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 495 U.S. 545 (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." In re Energy Resources Co., Inc., 495 U.S. 545, 551 (1990). 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. § 547. The definition of insider is found at 11 U.S.C. § 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 an 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

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?

(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?

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 § 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/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 has 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

4. Counterparties dealing with the debtor 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?

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. Recent amendments to the Bankruptcy Code give trade creditors an administrative priority claim (meaning it is entitled to be paid as a post-petition expense) equal to the value of goods received by the debtor within 20 days before the commencement of the case, if those goods were sold to the debtor in the ordinary course of business. 11 U.S.C. § 503(b)(9)

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. Recent amendments to the Bankruptcy Code provide a new, 45-day reclamation right in the bankruptcy context, although such rights are expressly subject to the prior rights of secured creditors, and thus will be quite limited in most contexts. A seller's right to reclamation under the UCC 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. 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

5. Enforcement

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

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, § 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 bylaw 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 $13,475 may commence an involuntary petition against the debtor. If the debtor has twelve or more creditors, three or more unsecured creditors whose claims aggregate $13,475 may commence the involuntary proceeding. Claims that are in bona fide dispute are not eligible as petitioning claims. 11 U.S.C. § 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. § 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.

New Bankruptcy Code chapter 15 provides a mechanism by which United States Bankruptcy Courts can be used to administer assets subject to the jurisdiction of United States courts.

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

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?

(a) In the Bankruptcy Court

Schedules: Bankruptcy Code section 521(a)(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).

Co-operation: Bankruptcy Code section 521(a)(3) requires that the debtor co-operate with any trustee to enable the trustee to discharge his duties under the Bankruptcy Code. In a liquidation case, that co-operation will ordinarily relate to informing the trustee of and assisting in locating property of the estate in the possession of third parties. Co-operation 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 co-operate 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(a)(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

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.

Limitations periods vary from state to state, so practitioners should review limitations issues on a case-specific basis. As a general rule, however, with respect to cause of action arising under state law, under the so-called Erie doctrine, federal courts apply the statute of limitations that the forum state would apply. See *Guar. Trust Co. v. York*, 326 U.S. 99, 109-10 (1946).

Typically, when a conflict arises between two states' statutes of limitations, the limitations period of the forum state will apply, even if the action is barred in another jurisdiction. See Restatement (Second) of Conflicts of Law § 142(2). Practitioners should confirm the application of those general principles to their particular case. Also, even if the statute of limitations of the forum jurisdiction applies, that does not foreclose the application of the laws of another jurisdiction to the substantive issues in the case. As noted earlier in this chapter, conflict of laws questions are complicated, and the rules vary among jurisdictions, so practitioners should think carefully about how conflict of law rules apply to a particular case, including limitations issues.

QUESTION 9

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 have the foreign proceeding recognized in the United States. See generally 11 U.S.C. sec. 1501 et seq. Such relief may include issuance of a preliminary injunction, pending a final hearing on recognition, Once a foreign proceeding is formally recognized following notice and hearing to creditors (a process which is largely ministerial if all procedural requiremsents are satisfied), the automatic stay imposed by Section 362 of the bankruptcy code applies automatically.

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 factors including 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.

Once the Bankruptcy Court formally recognizes a foreign proceeding, then the foreign representative of the debtor may, except in very limited circumstances, prosecute claims seeking the recovery of preferences, fraudulent conveyances and the turnover of the debtor's property. See 11 U.S.C. sec. 1523(a). In practice, that means that 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

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?

Insurance for officers and directors

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 none-the-less 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

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 receding 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 § 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 § 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 § 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. Such a debtor 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. § 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 co-operate 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 § 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 not withstanding a lack of co-operation 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, including a discussion of the potential material Federal tax consequences of the Plan to the debtor, any successor to the debtor, and any hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the Plan, but adequate information need not include such information about any other possible or proposed Plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information.

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 five 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 (excepting insiders) 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 not withstanding the Debtor's failure to satisfy the requirement of 1129(a)(8). Section 1129(b) provides that the Court may confirm the Plan not withstanding 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.

Not withstanding 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 unsecured can be expected to hold out for the best they can negotiate.

4. The new value exception to the Absolute Priority Rule

The 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 not withstanding 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 Snyder, 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, 119 S. Ct. 1411 (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." 526 U.S. at 453; 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 and a competing reorganization Plan." 526 U.S. at 454;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, not withstanding 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.

VIETNAM

QUESTION 1

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

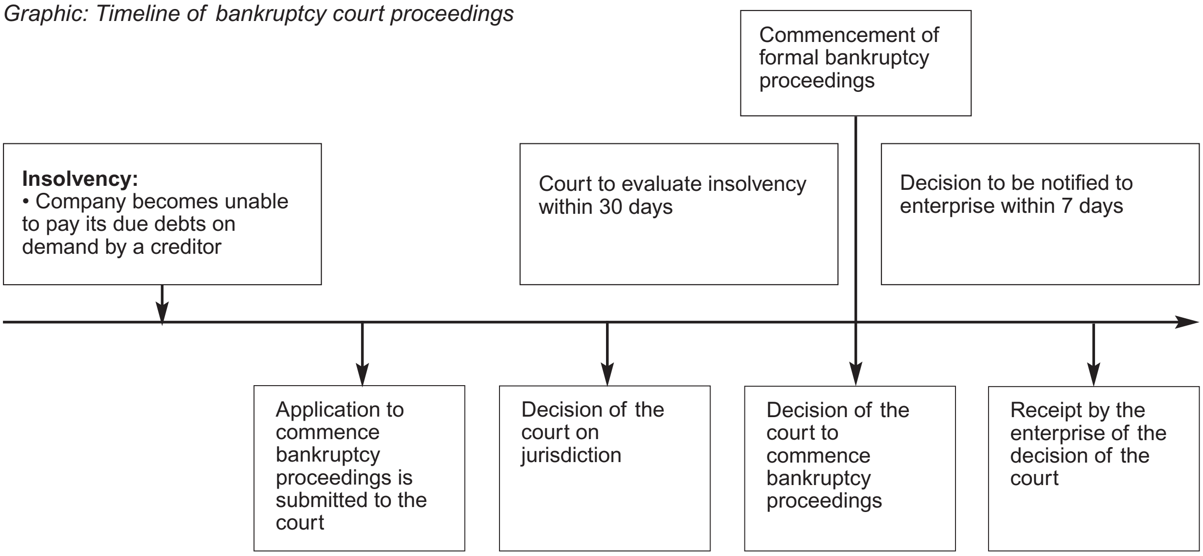
What is the length of the period ending with formal insolvency proceedings during which transactions entered into by a company are vulnerable to attack or are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company?

1.1 Introduction and Overview

1.1.1 The main legal instruments governing enterprise[1] insolvency in Vietnam are the Law on Bankruptcy No. 21/2004/QH11 by the National Assembly dated 15 June 2004 which took effect on 1 January 2005 (Law on Bankruptcy)[2] as well as its implementing regulations, including Resolution No. 03/2005/NQ-HDTP of the Supreme People's Court dated 28 April 2005 guiding the implementation of a number of provisions of the Law on Bankruptcy (Resolution 03) and Decree No. 10/2009/ND-CP of the Government dated 6 February 2009 on penalties for administrative breaches committed during the process of bankruptcy proceedings (Decree 10).

1.1.2 Under the Law on Bankruptcy, formal insolvency proceedings commence with the bankruptcy court's decision to commence bankruptcy procedures[3] which the court will issue if it has determined that the enterprise is insolvent. Prior to this, after an application to commence bankruptcy proceedings has been made, the court considers whether it has jurisdiction over the case and issues a notice accepting jurisdiction over the bankruptcy case and then has 30 days to evaluate whether the enterprise is indeed insolvent and to issue a decision to commence bankruptcy proceedings[4].

Graphic: Timeline of bankruptcy court proceedings



[1] The Law on Bankruptcy also governs co-operatives, partnerships and other commercial businesses, but does not include personal bankruptcy for which no framework currently exists in Vietnam. A number of special regulations apply to specially regulated enterprises (such as banks, insurance companies and other financial institutions). These are not separately addressed in this chapter.

[2] The Law on Bankruptcy is currently under review by the National Assembly, Vietnam's parliament. The Standing Committee of the National Assembly has indicated that it intends to submit comprehensive amendments to the Law on Bankruptcy in late 2013.

[3] Article 28.1 of the Law on Bankruptcy.

[4] Article 28.1 of the Law on Bankruptcy. The 30 days-period commences from the date of payment of court fees, unless the applicant is exempt from these.

1.1.3 Under Article 3 of the Law on Bankruptcy, any enterprise or co-operative which is unable to pay its due (unsecured or partially unsecured) debts on demand by a creditor shall be deemed to have become insolvent. The law therefore applies a “cash-flow” test only but requires, in addition to the financial inability to service a due debt, that the creditor has made an unsuccessful request for payment. Accordingly, the failure to make a due payment (e.g. where the payment falls due on a particular date) is not sufficient unless and until a claim has been submitted by the creditor to the company[5].

1.1.4 There is no “balance-sheet” test (as, for example, under English or German law) where an enterprise may also be deemed insolvent once its liabilities exceed its asset base.

1.1.5 “Clawback” provisions and transactions vulnerable to be attacked under the Law on Bankruptcy are set out in section 1.2 below. Transactions that may be attacked on grounds that are not necessarily based on an insolvency situation, but which, in practice, have a high relevance when an enterprise becomes bankrupt, are addressed in section 1.3 below. Personal liability of directors and other officers of the company is addressed under question 2 below.

1.2 Clawback provisions and transactions vulnerable to attack under the Law on Bankruptcy

Voidable transactions entered into before the acceptance of jurisdiction by the bankruptcy court

1.2.1 The main “clawback” provision relating to transactions during the “twilight period” is set out in Article 43.1 of the Law on Bankruptcy. According to the provision, the following transactions may be voided by the bankruptcy court if they were conducted by an enterprise which has become insolvent within a period of three months prior to the date on which the court accepted jurisdiction over the petition to commence bankruptcy procedures:

(a) donations of moveable or immoveable property to another person;

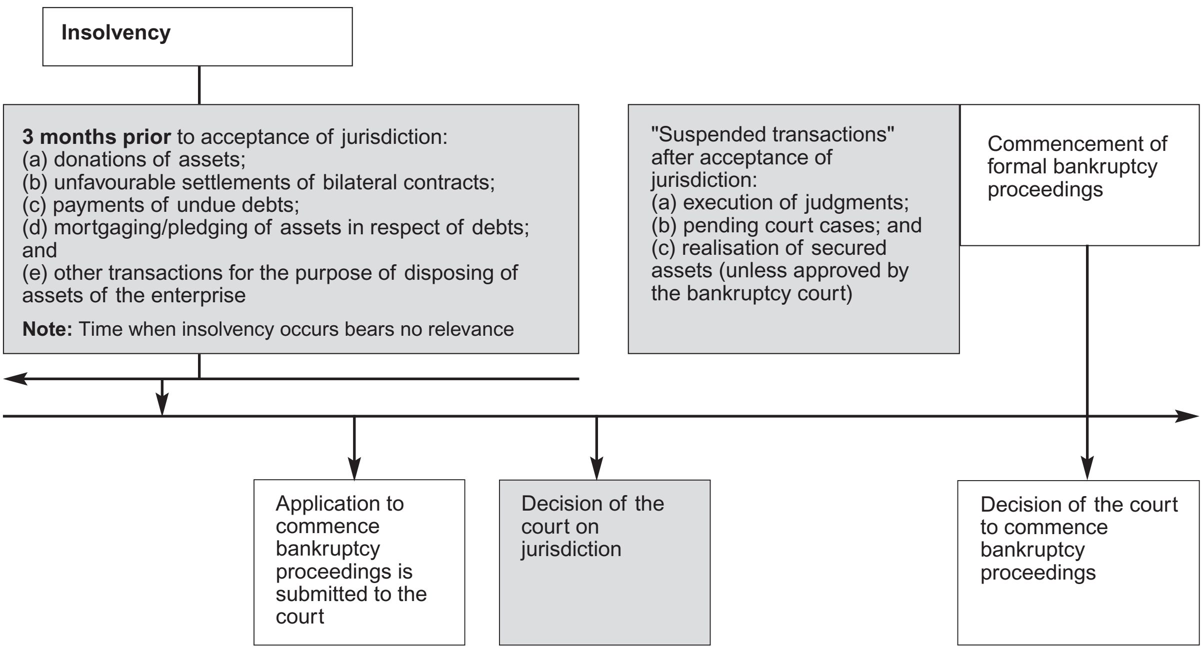
(b) settlement of bilateral contracts in which the obligation of the enterprise or co-operative is clearly greater than that of the other party;

(c) payment of undue debts;

(d) mortgaging or pledging of assets in respect of debts; and

(dd) other transactions for the purpose of disposing of assets of the enterprise or co-operative.

Graphic: Voidable transactions under the Law on Bankruptcy



1.2.2 The key date to determine a voidable transaction is therefore the date when the bankruptcy court has issued a decision to accept jurisdiction over the matter and transactions that meet the above criteria may be challenged if entered into three months before the acceptance of jurisdiction by the bankruptcy court (although creditors may only apply to the court to declare the transaction void after the court has rendered a decision that the enterprise is indeed insolvent, i.e. the decision to commence bankruptcy procedures). Transactions that the insolvent enterprise has entered into before the three-month period are immune against attack under the Law on Bankruptcy, although, in the circumstances set out under section 1.3 below, creditors or the liquidation committee may still be able to rely on non-bankruptcy specific grounds to attack such transactions and to recover assets or value for the insolvent enterprise’s parcel of assets.

[5] See also Article 13.2(dd) of the Law on Bankruptcy. Note: English translations of Vietnamese regulations customarily refer to lit. (dd) instead of the Vietnamese alphabet-specific lit. (®). These references are maintained throughout the article for the sake of consistency with this practice.

1.2.3 The three-month period is obviously very short, in particular as it is not determined by reference to the insolvency as such (or whether the enterprise has become insolvent as a consequence of the transaction) but is simply based on the date when the court has accepted jurisdiction over the matter. In practice, although the bankruptcy court is required to issue a decision on whether to accept jurisdiction without delay after an application has been submitted (provided that the application is formally in order), it can take a substantial time before a decision is rendered, further limiting creditors' rights with regard to voiding unfavourable transactions.

1.2.4 What is more critical is that the law does not allow for different periods to distinguish between transactions that were deliberately carried out to the detriment of the company and its creditors and other transactions that may simply favour a particular creditor in comparison to other unsecured creditors (such as providing security to a creditor that is becoming concerned about the financial situation of an enterprise and demands security). Tests that are common in other, more developed jurisdictions (e.g. whether a director had knowledge of the insolvency or of the precarious financial condition that the enterprise was in at the time of the transaction, or whether the director should have known that the enterprise was about to become insolvent) are not reflected in the Law on Bankruptcy. Nor does the Law on Bankruptcy provide for longer periods during which a transaction may be attacked in the case of transactions between the enterprise and certain related persons (related companies or related parties of the enterprise's management)[6].

1.2.5 An application to the court to declare a voidable transaction invalid may only be made by either an unsecured creditor (which includes partly secured creditors where the security does not cover their claim in full) or the liquidation committee[7].

Voidable transactions entered into before the decision to commence bankruptcy proceedings is issued

1.2.6 In addition to the voidable transactions set out above, the following transactions or discharge of asset obligations may also be attacked pursuant to Article 27.1 of the Law on Bankruptcy if they are conducted during the period after the court has accepted jurisdiction of a bankruptcy matter but before the official decision to commence bankruptcy procedures has been issued:

(a) execution of civil judgments over assets where the enterprise or co-operative is the judgment debtor;

(b) resolution of any court case including a claim that the enterprise or co-operative discharge its asset obligations; and

(c) realisation of secured assets of the enterprise or co-operative for a secured creditor, except in cases where the court so permits.

1.2.7 The Law on Bankruptcy requires that these be "temporarily suspended"; however, it is understood that any transaction or discharge of an asset obligation (e.g. the realisation of security by a secured creditor) may be challenged if taken in violation of the provisions of Article 27 of the Law on Bankruptcy.

1.2.8 In this context, Section II.2.3 of Resolution 03 details the requirements for the bankruptcy court to permit the realisation of secured assets by a secured creditor after the court has already accepted jurisdiction over a bankruptcy application. Accordingly, the secured creditor that applies to enforce a security must demonstrate to the bankruptcy court that:

(a) the insolvent company's obligations have fallen due;

(b) the realisation of the security assets does not affect the production and business activities of the enterprise; and

(c) the applicant can raise "legitimate reasons" for the requirement to realise the secured assets and that the realisation of the security has become "necessary".

1.2.9 In practice, the bankruptcy courts do not appear to apply an overly onerous test to the "legitimate reasons" and the "necessity" for the enforcement. A request for the realisation of security should therefore be approved where the creditor can demonstrate that the company has defaulted on its payment obligations and the relevant conditions of the security agreement for the enforcement of the security have been met. However, the courts do retain some discretion in permitting the realisation of the security. In particular, they may limit the enforcement on the basis that the insolvency proceedings should target the recovery of the business operations of the company and that the realisation of certain security items may affect the production capacity and business activities of the enterprise and, accordingly, would prevent the targeted recovery of the business.

1.3 Transactions vulnerable to attack under non-bankruptcy specific regulations

1.3.1 Additional grounds for attacking civil transactions that the insolvent company may have entered into exist outside of the Law on Bankruptcy. While these are not dependent on an insolvency situation, such transactions tend to become increasingly relevant in the event that a company becomes insolvent and, in practice, there is an increased risk of such transactions being carried out to the detriment of creditors when an enterprise becomes financially troubled.

[6] Related-party transactions may still be attacked if they have not been properly authorised, as is discussed in section 1.3.4 below. However, to the extent that these have been approved by the company, they may not be attacked even where they disproportionately favour the related party.

[7] Article 44.1 of the Law on Bankruptcy.

1.3.2 By way of an overview, the most relevant scenarios (and their respective vulnerability periods) include:

	Legal basis	Vulnerability period
(a)	Unauthorised related-party transactions Certain related-party transactions between the company and related parties of the company that were not approved by the relevant corporate bodies, pursuant to Article 120 of the Law on Enterprises for joint stock companies ("JSCs") and Articles 59 and 75 of the Law on Enterprises for limited liability companies ("LLCs").	The Law on Enterprises does not provide for a specific period during which the transaction may be challenged; possibly, a two-year period may be applied pursuant to Article 136.1 of the Civil Code.
(b)	Transactions that are "ultra vires" for the company Transactions that the company has entered into beyond its licensed scope of operations (pursuant to Article 128 of the Civil Code).	No specific period.
(c)	Transactions beyond the scope of authority of the legal representative Certain transactions where the so-called legal representative (the concept is explained in additional detail in sections 1.3.9 and 1.3.10 below) acts beyond the scope of authority set out in the charter of the company.	The Law on Enterprises does not provide for a specific period during which the transaction may be challenged; possibly, a two-year period may be applied pursuant to Article 136.1 of the Civil Code.
(d)	Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company Transactions where a director or employee acts on behalf of the company but beyond the power to represent the company (pursuant to Articles 145 and146 of the Civil Code).	No specific period.
(e)	Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions Dividend payments that were made in breach of the conditions for dividend payments and/or payments made for the redemption of shares by the company (e.g. in violation of the company's obligation to be able to meet its obligations to creditors under Article 94 of the Law on Enterprises for JSCs and Articles 43 and 61 for LLCs).	No specific period.

1.3.3 The above-mentioned transactions are invalid[8] per se without the requirement that they must be specifically challenged. However, if such transactions have been entered into, they may have been performed or may appear to be valid unless the grounds that render such transaction invalid are actively raised by a creditor or the liquidation committee in the event of a bankruptcy to restore the status quo ante. The issue of personal liability of the directors and officers of the company in the context of these transactions is addressed in section 2 below.

Unauthorised related-party transactions

1.3.4 Related-party transactions between the company and certain related parties (including, for example, its shareholders, directors, and related persons of these) are subject to the approval by different corporate bodies depending on the form of the company and the value of the transaction. The approval requirements are as follows:

(a) in a JSC, these transactions would be subject to the approval by the board of management unless the value of the transaction equals at least 50 per cent. of the value of the company's assets (or a lesser amount if so provided in the company's charter) in which case the general meeting of shareholders must approve the transaction[9];

(b) similarly, in an LLC with at least two members, the so-called members' council is required to authorise any related-party transactions[10]; and

(c) in an LLC with a single member (essentially a company with a single shareholder), related-party transactions must be approved by way of a vote among the company chairman (or members' council, where a members' council has been established), the general director and the so-called "inspector(s)"[11].

1.3.5 If these formal requirements are not complied with, the relevant transaction is void and may be challenged by a creditor or the liquidation committee. Of note, unless the charter provides otherwise, there is no requirement for these transactions to be carried out at proper arm's length so the approval requirement per se does not necessarily abolish the risk of abuse.

1.3.6 The Law on Enterprises does not provide for a specific period during which a related-party transaction that has not been properly approved may be challenged. There is an argument that the two-year period that Article 136.1 of the Civil Code provides for certain invalid transactions may be applied by way of an analogy; however, this is not tested under Vietnamese law.

[8] The transactions under 1.3.2(c) and (d) may still form a valid contract between the person who has exceeded his authority in acting on behalf of the company and the counter-party and may then be challenged by the counter-party who thought to contract with the company.
[9] Article 120 of the Law on Enterprises.
[10] Article 59 of the Law on Enterprises.
[11] Article 75 of the Law on Enterprises.

Transactions that are "ultra vires" for the company

1.3.7 Under Vietnamese law, a company may only enter into commercial transactions that fall within the licensed scope of activities of the company. Contracts and transactions that are outside of the permitted scope are deemed invalid[12]. This may provide grounds for a creditor or the liquidation committee to challenge commercial transactions, for example, where the company has provided credit to related parties outside of a regular commercial transaction within its regular scope of activities.

1.3.8 Neither the Law on Enterprises nor the Civil Code provide for a specific period during which the invalidity of the transaction would have to be raised. As the requirement to act within the permitted scope of operations is a matter of public order, we believe that it is less likely that the two-year period set out in Article 136.1 of the Civil Code would be applied[13].

Transactions beyond the scope of authority of the legal representative

1.3.9 In Vietnamese companies, the so-called legal representative represents the company in entering into transactions, dealing with State authorities and acts overall on behalf of the company. The charter of a JSC determines whether the legal representative is the chairman of the board of management or its general director[14]. Likewise for LLCs, the charter provides whether the general director or the chairman of the members' council shall be the legal representative[15] (or, for one-member LLCs whether the company chairman holds this function[16]). The authority of the legal representative is based, in part, on Vietnamese laws and regulations (such as the Law on Enterprises) and may also be more closely defined in the company's charter. Vietnamese law is not clear on whether limitations that the charter imposes on a legal representative (e.g. in the form of approval requirements for certain transactions) render a transaction automatically invalid. However, there have been precedents, in particular where the legal representative acted fraudulently, where the Vietnamese courts have determined that transactions exceeding the authority provided in the charter were void. Creditors or the liquidation committee may be able to rely on this, for example where the legal representative has disposed of assets, provided credit or carried out other transactions to the detriment of the company which were outside of the scope of authority granted to the legal representative in the charter.

1.3.10 The Law on Enterprises does not provide for a specific period during which such a transaction may be challenged. There is an argument that the two-year period that Article 136.1 of the Civil Code provides for certain invalid transactions may, by way of an analogy, also be applied in this context; however, this is not tested under Vietnamese law. If the legal representative acted fraudulently, Article 136.2 of the Civil Code clarifies that no time-limit to challenge such a criminal transaction exists.

Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company

1.3.11 Under Vietnamese law, while a power of attorney may be given to other directors or employees of the company, the formal requirements for representation are relatively strict. It is therefore common to see transactions attacked that were entered into by a person other than the legal representative but where either (i) the authority given to the authorised person did not comply with these formal requirements or was not exercised in accordance with all formal requirements (such as the use of the company's seal), or (ii) where the authorised person acted beyond the power to represent the company[17].

1.3.12 In these circumstances, Vietnamese law does not provide for a specific period during which the transaction would have to be challenged.

Unlawful distribution of dividends/profits and unlawful payments for the redemption of shares or capital contributions

1.3.13 Dividend payments to shareholders and any distribution of profits to members of an LLC may only be made if the company is still in a position to meet its obligations to creditors following the distribution of dividends[18]. Shareholders (respectively members) that have received profit payments in breach of these requirements are required to reimburse the distributed profits to the company[19].

1.3.14 Similar considerations apply where the company has redeemed shares (in the case of a JSC) or the company has reduced its charter capital (in the case of a multi-member LLC)[20].

1.3.15 There is no specific timeline during which the unlawful distribution of dividends or the redemption of shares/capital would have to be challenged.

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12 Article 128 of the Civil Code.

13 In this contact, Article 136.2 of the Civil Code provides that transactions in breach of Vietnamese laws are invalid and that there is no time-limit to challenge these. This may, for example, be the case where the purpose of the transaction is unlawful

14 Articles 95 and 116.1 of the Law on Enterprises.

15 Articles 46 and 49.4 of the Law on Enterprises.

16 Article 67.5 of the Law on Enterprises.

17 Articles 145 and 146 of the Civil Code.

18 Article 94 of the Law on Enterprises for JSCs and Article 61 of the Law on Enterprises for LLCs.

19 According to Article 94 and 62 of the Law on Enterprises respectively.

20 According to Articles 92.1, 94 and 60.3 and 62 of the Law on Enterprises respectively.

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 Overview of company forms and types of directors and officers in Vietnam

2.1.1 Legal entities and company forms permitted under the Law on Enterprises include LLCs, JSCs, partnerships and private enterprises. LLCs and JSCs are by far the most common types of enterprises in Vietnam.

2.1.2 The Law on Enterprises provides for two types of LLCs, namely, multi-member LLCs and one-member LLCs (where there is only a single member having contributed capital to the company).

Multi-member LLCs

2.1.3 (a) A multi-member LLC must have at least two members and may not have more than 50. Members may be organisations or individuals. A multi-member LLC is managed by a so-called members' council (which includes all of the members – who may be individuals or representatives of corporate members), the chairman of the members' council, and may also include its general director.

(b) The general director is responsible for the company's day-to-day operations while the members' council provides both general oversight over the general director's management and the affairs of the company. The members' council also retains substantial decision-making authority over the company's strategy and fundamental decisions.

(c) An LLC with 11 members or more must have an inspection committee (sometimes also referred to as a supervisory board). Even where no inspection committee is required, the company's charter may provide that a 'voluntary' inspection committee be established within the company's corporate governance framework. The inspection committee has a role that is, in part, similar to that of an audit committee, although its reports are submitted directly to the members.

(d) Whilst the broader corporate governance system of LLCs thus more closely resembles that of a unitary company structure, LLCs with a larger number of members or those that have opted to establish an inspection committee bear certain elements of a two-tiered management structure. It is also important to note that the members' council has a dual function, including elements of a 'general meeting of shareholders' (or congregation of the owners of an LLC) as well as certain direct management functions. As such, it has certain rights and obligations that go beyond those of a traditional board of directors.

(e) In order to separate the members' council from its management role, larger LLCs , in particular those with foreign investment often establish a board of directors that more closely resembles that of the board of directors of companies established in common law jurisdictions, thereby filling the corporate governance gap between the members' council and the general director.

(f) Lastly, the charter of a multi-member LLC is required to provide whether the chairman of the members' council or the general director is appointed as the so-called 'legal representative' of the company. As noted above, the legal representative fulfils certain specific responsibilities of the company, in particular in entering into transactions and contracts, in representing the company before the courts, signing financial statements of the company, interacting with the authorities, and so forth.

One-member LLCs

2.1.4 (a) A one-member LLC is an LLC with a single investor, such as a 100 per cent. foreign-owned enterprise with only one parent company.

(b) The charter of a one-member LLC determines whether the general director acts as its legal representative or whether the so-called chairman of the company holds this position (the chairman being the owner's representative). However, the investor may also establish a members' council (and appoint more than one owner's representative) and/or a board of directors to govern the broader operations of the one-member LLC. The charter can further determine that the chairman of the members' council acts as the company's legal representative. Each one-member LLC is required to appoint between one and three inspectors who perform a function similar to that of an inspection committee of a multi-member LLC.

JSCs

2.1.5 (a) A JSC (or shareholding company) is a company whose charter capital is divided into shares. Shareholders may be corporate entities or individuals. The minimum number of shareholders is three and there is no restriction on the maximum number of shareholders. JSCs may take the form of either closely-held companies as well as listed or public companies in Vietnam (only JSCs may be listed and/or public companies).

(b) The highest decision-making body of a JSC is its general meeting of shareholders. A JSC is managed by a board of management[21] and a general director. JSCs with more than 11 individual shareholders, or one shareholder who owns more than 50 per cent. of the total number of shares, are required to have an inspection committee that has a role similar to that of an LLC and reports directly to the shareholders of the JSC. The chairman of the board of management or the general director – as determined by the company's charter – is the legal representative of the company.

2.2 General comments on liability of directors in Vietnam

2.2.1 In practice, the issue of directors' liability remains largely untested in Vietnam. This is in part due to the fact that in Vietnam, the owners are largely the company's directors. In addition, the overall application of the Law on Bankruptcy remains extremely limited. There is no system of binding precedents and court rulings are normally not published in Vietnam. It thus remains challenging in Vietnam to put forward a firm presentation of the (possible) application of the law by the courts or, for that matter, any empirical evaluation with a reliable degree of precision. There have, however, been a small number of reported cases of directors who have been held liable personally and have faced administrative or criminal prosecution. Civil cases, in particular actions brought by the company against a current or former director, seem rare.

2.2.2 Nevertheless, it is becoming more common to appoint external directors and managers and the Law on Enterprises and other regulations include more specific provisions on the liability of directors than was previously the case. It is therefore expected that these matters will be put to the test sooner rather than later.

2.2.3 A particular recent development in this regard is Circular 121/2012/TT-BTC dated 26 July 2012 by the Ministry of Finance providing regulations on corporate governance applicable to public companies (Circular 121) which sets out specific additional requirements, and corresponding liabilities, for directors of public companies (including listed JSCs as well as other public companies, i.e. JSCs with at least 100 shareholders). These are discussed in more detail in section 2.9(c) below.

2.3 Voidable transactions under the Law on Bankruptcy entered into during the "twilight period"

Currently, directors, in particular the company's legal representative, are not liable to the company or to creditors for having entered into voidable transactions under the Law on Bankruptcy during the "twilight period" except in the following circumstances:

(a) the voidable transaction coincides with a breach of the director's labour contract or services agreement with the company (this scenario is described in more detail in section 2.8 below);

(b) the voidable transaction coincides with a breach of the director's fiduciary duties or other duties of care owed to the company (this scenario is described in more detail in section 2.9 below); and

(c) these have involved transactions that constitute fraud against creditors or fraud against customers (these scenarios are described in more detail in sections 2.12 and 2.13 below).

Current Vietnamese bankruptcy regulations allow for the enterprise itself to be fined in the event that it enters into certain prohibited transactions without the consent of the bankruptcy court after it has received the decision of the court that bankruptcy proceedings will be commenced (i.e. after the "twilight period" has ended)[22]. However, these relate to obligations of the enterprise as such and not to its directors personally.

2.4 Unauthorised related-party transactions

(a) The legal representative as well as the relevant "related person" with whom the unauthorised transaction has been entered into (which may include a member/shareholder or a director of the company as well as other related persons) are liable to compensate the company for any damages arising from the unauthorised transaction and return to the company any benefits gained from the performance of such contract or transaction.

(b) (i) Liability is civil.

(ii) Personal liability extends to the full loss incurred by the company and is generally joint and several together with any other related person that is liable to the company (i.e. the related person that has entered into the unauthorised transaction). However, the Vietnamese courts have substantial discretion in determining the extent of the loss and any allocation among the obligors.

(iii) The courts may therefore decide that the liability of the legal representative should be proportionate to his/her involvement (e.g. of a lesser extent where the legal representative was not directly involved and the unauthorised transaction was carried out by another director or employee under power of attorney). The legal representative also has recourse against the related parties that are jointly liable with the legal representative to the extent of their respective contribution[23].

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[21] Although referred to as a 'board of management' in Vietnam , such board of management is similar to the board of directors in common law jurisdictions. For the sake of consistency with Vietnamese legal terminology, the term 'board of management' is used throughout this chapter when reference to the board of a JSC is made.

[22] Article 12 of Decree 10.

[23] Article 298.2 of the Civil Code.

(iv) There is no specified period.

(v) Under the Law on Enterprises, the liability for entering into an unauthorised related-party transaction attaches to the legal representative irrespective of whether the legal representative acted with intent or only negligently (e.g. where the legal representative did not know that the contracting party was a related person). It is not clear under Vietnamese law whether the legal representative could successfully invoke that he was not directly involved in the transaction (as in the example above where the legal representative did not act directly).

2.5 Transactions that are "ultra vires" for the company

In these circumstances, the legal representative may be liable for misrepresentation to the counterparty that has entered into the transaction. In addition, in the event that the company has incurred any damages or losses, the legal representative may also be liable for breach of the labour contract or director's service agreement with the company (this scenario is addressed in more detail under section 2.8 below).

2.6 Transactions beyond the scope of authority of the legal representative

The liability of the legal representative is identical to those set out under section 2.5 above. In addition, where the legal representative colluded with the counterparty against the interests of the company, the legal representative and the counterparty are jointly liable to the company[24].

2.7 Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions

(a) The Law on Enterprises[25] provides that members of the board of management of a JSC are jointly liable together with shareholders for debts of the company up to the amount of dividends or payments for redemptions of share capital that have been distributed to shareholders unlawfully but which cannot be recovered. There is no corresponding provision for LLCs and it is unclear under Vietnamese law whether a comparable liability would be imposed on the members of a members' council or the company chairman in the event that an unlawful distribution of profits has been made (or where capital has been redeemed in contravention of the legal requirements for a redemption of capital). However, there is no reason to treat these two scenarios differently and this may simply have been an oversight of the legislator.

(b) (i) Liability is civil.

(ii) The personal liability of members of the board of management is limited to the lower of the amount that has been distributed and the debt of the company that cannot be serviced as a consequence of the distribution. The law is not clear on whether the obligation is owed to the company (i.e. repayment is to be made to the company) or whether creditors would have a direct claim, although the wording of the law suggests the latter. Accordingly, the company and the members of the board of management would then become joint and several debtors until and unless the members have satisfied one or more creditors' claims up to the amount that has been unlawfully distributed.

(iii) The Law on Enterprises provides that the members of the board of management are jointly liable. A member has recourse against other members of the board of management who are jointly liable to the extent of their respective contribution[26].

(iv) There is no specified period.

(v) Under the Law on Enterprises, the liability for distributing dividends without the company meeting the legal requirements for the distribution initially attaches to all members of the board of management irrespective of whether they were involved in the decision (e.g. even where a member of the board of management was absent from the meeting when the distribution was resolved). It is not clear under Vietnamese law whether a member could successfully invoke that he was not involved in the decision or whether this would only mean that the member would be given full recourse to other members (but would remain liable to creditors nevertheless).

2.8 Breach of labour contract / service agreement

(a) Certain acts carried out by the legal representative and/or other directors of the company during the "twilight period" may constitute a breach of their respective labour contracts (where there is an employment relationship with the director) or the service agreement with the director. This may, for example, occur where the management fails file on time for bankruptcy or where preferences are granted. The legal representative and/or other directors may then be liable for breach of their contractual arrangement with the company.

(b) (i) Liability is civil.

(ii) Where more than one director has acted in concert with another (or has failed to act), they would be jointly liable to the company.

(iii) A director has recourse against other directors that are jointly liable to the extent of their respective contribution[27].

(iv) There is no specified period.

(v) There are no specific defences. However, please see the section on indemnity at question 10 below.

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[24] Article 146.3 of the Civil Code.
[25] Article 94 of the Law on Enterprises.
[26] Article 298.2 of the Civil Code.
[27] Article 298.2 of the Civil Code.

2.9 Breach of other directors' duties

(a) Directors owe certain fiduciary duties to the company with the details depending on the type of director and the type of company. Broadly, directors must act in a fiduciary and diligent manner and in the best interests of the company. Labour contracts with directors (respectively service agreements between them and the company) will typically incorporate a director's obligations under Vietnamese law as part of the contractually owed duties (and as such, breaches of these are also breaches of the underlying contractual arrangement, as discussed in section 2.8 above). However, where this is not the case, a director still owes these duties to the company under Vietnamese law and may be held personally liable in the event of a breach.

(b) (i) Liability is civil.

(ii) Where more than one director has acted (or has failed to act), they would be jointly liable to the company.

(iii) A director has recourse against other directors that are jointly liable to the extent of their respective contribution[28].

(iv) There is no specified period.

(v) There are no specific defences. However, please see the section on indemnity at question 10 below.

Directors' duties in public companies

(c) Circular 121 on the corporate governance of public companies lists in comparatively more detail the responsibilities and duties of various directors of public JSCs, including:

(i) for members of the board of management: "to implement their duties in an honest and diligent manner in the best interests of the shareholders and the company"[29]; and

(ii) for the inspection committee: "to supervise the financial situation of the company, the legality of activities of the members of the board of management, of the executive Director (General Director) and other managers, the co-ordination of activities between the inspection committee and the board of management, the executive Director (General Director) and the shareholders, and other duties stipulated by law and the company charter in order to protect the legitimate interests of the company and its shareholders"[30].

(d) Although Circular 121 as such does not provide much detail on the ensuing liability of directors from these responsibilities, Article 36.1 of the Model Charter for Public Companies attached to Circular 121 provides that "Members of the Board of Management, members of the Inspection Committee, the executive Director (General Director) and other managers who breach their obligations and responsibilities for honesty and prudence or fail to fulfil their obligations with due diligence and professional capability must be responsible for any loss and damage caused by their breach".

(e) The Model Charter is, per se, not mandatory for public companies and public companies may adopt charters that include provisions that differ from the above. However, the Model Charter (i) sets out the expectation of the regulator of public companies (the Ministry of Finance and its agency, the State Securities Commission, which directly supervises public companies) and (ii) tends to be a benchmark in practice when the regulator reviews filings for IPOs and/or listings on Vietnam's stock exchanges. As such, it is likely that the specific liabilities of directors of public companies as set out in the Model Charter will substantially shape directors' liability in public companies.

2.10 Failure to file a petition to commence bankruptcy proceedings

(a) Where the legal representative fails to file a petition for bankruptcy proceedings upon becoming aware that the company has become insolvent, the legal representative is subject to an administrative fine[31]. The administrative fine that may be applied ranges from VND 1 million to VND 3 million (about USD 50 to USD 150) - too low to act as a real deterrent.

(b) (i) Liability is administrative.

(ii) The legal representative is personally liable for the full amount of the administrative penalty.

(iii) A fine may also be imposed on the owner of the enterprise. However, in the event that two fines are issued, the owner and the legal representative are both personally liable for the fine.

(iv) The legal representative must file a petition to commence bankruptcy proceedings within three months of becoming aware that the company has become insolvent in order to avoid being liable[32].

(v) There is no specific defence available to the legal representative. However, in light of the two main conditions that (i) the legal representative had to be aware that the company was insolvent and (ii) has a three month time-period to comply with the obligation to file for bankruptcy, the scope of application of the provision is very narrow (in addition to the fact that the range of administrative fines is very small).

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[28] Article 298.2 of the Civil Code.
[29] Article 13.2 of Circular 121.
[30] Article 21.1 of Circular 121.
[31] Article 15 of the Law on Bankruptcy, Article 9 of Decree 10.
[32] Article 15 of the Law on Bankruptcy.

2.11 Falsification of accounting records

(a) Decree 185/2004/ND-CP dated 4 November 2004 of the Government on sanctioning of administrative violations in the accounting domain (as amended by Decree 39/2011/ND-CP dated 26 May 2011) sets out a number of accounting-related administrative violations, including the falsification of records for accounting purposes, making or instructing incorrect accounting entries and so forth. If these violations are committed by a director, the director is subject to various administrative penalties, although for each infraction, the maximum administrative fine that may be applied is capped at VND 30 million (about USD 1,500).

(b) (i) Liability is administrative.

(ii) The director who was involved in the violation is personally liable for the full amount of the administrative penalty.

(iii) In the event that more than one fine is issued to different persons involved in the violation, each person is personally liable for the administrative fine issued to them.

(iv) There is no specified period.

(v) There is no specific defence available to the director involved, although Decree 185 recognises a number of mitigating circumstances that, if present, must be considered when the amount of the fine is determined (such as self-reporting of the violation, the violation being a first-time offence and others).

2.12 Transactions in fraud of creditors

(a) Under Article 139 of the Criminal Code, a director who appropriates property through fraud commits a criminal offence. This can include property or assets obtained by the company which was already insolvent at the time of the transaction.

(b) (i) Liability is criminal.

(ii) The offence is punishable by imprisonment. The maximum term of imprisonment is dependent on the value of the property or assets that were defrauded. Offenders may also be banned from holding certain posts, such as directorships.

(iii) A civil action may be linked to a criminal action in Vietnam but only where there are specific civil grounds to claim damages that relate to the same subject matter that is being dealt with by the criminal court. This would typically be the case in a fraud-related matter as the offender would also be liable under civil law to reimburse the victim pursuant to Article 604 of the Civil Code.

(iv) There is no specified period.

(v) There is no specific defence available to the director involved, although the Criminal Code recognises a number of mitigating circumstances.

2.13 Transactions in fraud of customers

(a) Under Article 162 of the Criminal Code, a person who defrauds customers causing serious loss[33] to customers commits a criminal offence. This can include, for example, a situation where a materially insolvent company takes deposits or prepayments from customers but is then unable to deliver the products or services for which the deposits have been taken.

(b) (i) Liability is criminal.

(ii) The offence is punishable by imprisonment and/or a fine. The maximum term of imprisonment is three years. Offenders may also be banned from holding certain posts, such as directorships.

(iii) A civil action may be linked to a criminal action in Vietnam but only where there are specific civil grounds to claim damages that relate to the same subject matter that is being dealt with by the criminal court. This would typically be the case in a fraud-related matter as the offender would also be liable under civil law to reimburse the victim pursuant to Article 604 of the Civil Code.

(iv) There is no specified period.

(v) There is no specific defence available to the director involved, although the Criminal Code recognises a number of mitigating circumstances.

2.14 Criminal liability applicable to directors of State-Owned Enterprises ("SOEs")

Selected provisions under which directors of SOEs may be criminally liable

2.14.1 Vietnam's Criminal Code includes a number of offences that provide for the criminal liability of State officials in the area of economic management. These may include (without limitation):

(a) Article 165 of the Criminal Code: Deliberately acting against the State's regulations on economic management, causing serious consequences

[33] The "seriousness" of which is not more specifically defined, leaving substantial discretion to the courts.

Article 165 of the Criminal Code criminalises the abuse of power or position (e.g. of directors in SOEs) that causes losses to the State.

(b) Article 167 of the Criminal Code: Making false reports on economic management

Article 167 of the Criminal Code criminalises false reporting and the submission of falsified documents causing serious consequences to the implementation of the State's socio-economic plans.

(c) Article 281 of the Criminal Code: Abusing positions and/or powers while performing official duties

Article 281 of the Criminal Code criminalises the abuse of position or powers by State officials for self-seeking purposes causing damage to the State and/or to the legitimate rights and interests of citizens.

(d) Article 282 of the Criminal Code: Abusing powers while performing official duties

Article 282 of the Criminal Code may apply where State officials (including directors of SOEs), for self-seeking or other personal motivation, act beyond their powers and contrary to their official duties, causing damage to the interests of the State and/or the legitimate rights and interests of citizens.

(e) Article 284 of the Criminal Code: Forgery in the course of employment

Under Article 284 of the Criminal Code, a director who, for reasons of personal motivation, falsifies or forges documents or signatures, commits a criminal offence. Of note, there needs to be an element beyond the falsification of company records, such as the intent to obtain a personal gain.

(f) Article 285 of the Criminal Code: Negligence of responsibility causing serious consequences

Under Article 285 of the Criminal Code, State officials may be criminally liable for negligent mismanagement of State assets.

2.14.2 In practice, there have been a number of cases where directors who were State officials have been convicted for the mismanagement of assets (including in the recent high-profile bankruptcy matter of Vietnam's largest State-owned shipbuilding conglomerate Vinashin). While a number of these offences require that the director must be a State official, other provisions apply irrespective of this and only require that the director is involved in the management of SOEs (but need not be a State official).

2.15 Incurring further credit

There is no separate concept or provision that would forbid the company or its directors from incurring further credit unless in the context of the above grounds for civil, administrative or criminal liability of the director (most notably, fraud). This issue is further discussed under 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 No "de facto" or "shadow directors" in Vietnam

In Vietnam, only formally appointed or elected directors have the status of directors and are subject to the respective provisions holding them liable. There is no concept of de facto or shadow directors.

3.2 Liability of other persons

3.2.1 A number of the legal grounds for personal liability set out under question 2 above apply to the person who was acting in the circumstances irrespective of whether such person was a director of the company or not.

Overview of liability of other persons

3.2.2

Offence / activity	Persons liable (other than directors)	Extent of liability
Unauthorized related- party transaction	Related party	Same as for legal representative
Transactions beyond the scope of authority of the legal representative	Counterparty to the transaction if the counterparty colluded with the legal representative	Same as for legal representative
Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions	Member or shareholder that has received dividends or payments for redemption of shares / capital	Same as for members on the board of management
Falsification of accounting records	Person falsifying accounting records	Same as for director
Transactions in fraud of creditors	Person committing fraud	Same as for director
Transactions in fraud of customers	Person committing fraud	Same as for director

3.2.3 Counterparties to a voidable transaction may be liable to rescind the transaction. This is addressed in more detail under question 4 below.

3.3 Extent of liability of other persons

The liability of the non-directors set out under section 3.2 is, in each case, identical to that of the director(s).

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 As noted under sections 1.2 and 1.3 above, certain transactions entered into during the twilight period may be voidable under the Law on Bankruptcy or they may never have had legal effect in the first place; this will only become apparent in a bankruptcy situation when the operations of the company become subject to particular scrutiny.

4.1.2 In the case of voidable transactions under the Law on Bankruptcy, the law deems that the contracting party to these transactions enjoys less protection than the bankruptcy estate of the insolvent company and, ultimately, its creditors. Given the limited scope of application of the clawback provision (in terms of both the limited duration of the clawback period and the limited cases in which a transaction may be attacked by the liquidation committee or an unsecured creditor), this appears justified.

4.2 Heads of challenge and requirements to set aside voidable transactions under the Law on Bankruptcy

Donations of moveable or immoveable property to another person[34]

4.2.1 (a) The bankruptcy court may rule that the donation of any moveable or immoveable property from the company to another person was unlawful if it occurred during the three months prior to the acceptance of jurisdiction over the bankruptcy of the company. The counterparty who received the assets is required to return such property if the transaction is attacked. The enforcement of the decision of the bankruptcy judge must be carried out by the liquidation committee (employing the civil enforcement authorities where the order is not voluntarily complied with).

[34] Article 43.1(a) of the Law on Bankruptcy.

(b) There is no specific defence available to the counterparty. However, if the transaction included the donation of moveable assets and the counterparty has already sold (or even donated) these to a bona fide third party, the assets cannot be reclaimed[35]. It is not clear whether the proceeds from such transaction would automatically substitute for the donated property and would have to be provided to the insolvent company. This does not apply to immoveable property which may not be acquired by a third party bona fide purchaser or acquirer unless the acquisition took place by way of a public auction or based on a State decision (such as the enforcement of a court order)[36].

Settlement of bilateral contracts in which the obligation of the enterprise is clearly greater than that of the other party[37]

4.2.2 (a) Where a transaction has occurred that is clearly unfavourable to the (now insolvent) company during the clawback period, the counterparty also enjoys no protection and the transaction may be attacked. The provision intends to capture "fire sales" or transactions that may have taken place under particular duress from the perspective of the bankrupt company. The entire transaction would be voided and it would not be maintained at a level which would be seen as balanced or adequate. There is, however, no guidance in the Law on Bankruptcy nor in the implementing regulations as to what constitutes a "clearly greater" obligation on the part of one of the companies involved in the transaction and when exactly the consideration given by the counterparty would be considered "clearly less" than what the counterparty had received.

(b) There is no specific defence available to the counterparty. If the transaction involved moveable assets that have already been acquired by a bona fide third party, the assets cannot be reclaimed[38]. It is also not clear whether the proceeds from such a transaction would automatically substitute for the donated property and would have to be provided to the insolvent company.

Payment of undue debts[39]

4.2.3 (a) In the event that the (now insolvent) company has paid an undue debt to the counterparty during the clawback period, the counterparty will be required to repay the debt.

(b) There is no specific defence available to the counterparty.

Mortgaging or pledging of assets in respect of debts[40]

4.2.4 (a) A creditor that obtained (additional) security during the clawback period would have to return such security (respectively release the security) provided by the insolvent company.

(b) In the event that the creditor has already enforced the security prior to the court's decision to accept jurisdiction over the bankruptcy, a bona fide third party buyer would be entitled to keep the assets. It is not clear whether the proceeds from such a transaction would automatically substitute for the donated property and would have to be provided to the insolvent company.

Other transactions for the purpose of disposing of assets of the enterprise or co-operative[41]

4.2.5 (a) While the voidable transactions set out under sections 4.2.1 to 4.2.4 above do not require any intent on the part of the company (respectively, its management) that later becomes insolvent, Article 43.1(dd) of the Law on Bankruptcy allows transactions to be voided that were entered into for the purpose of disposing of assets of the company.

(b) There is no specific defence available to the counterparty. It is, however, not clear whether the provision is to be construed so that both parties to the transaction had to act with intent and, in particular, had to be aware of the impending bankruptcy or whether it is sufficient that the company (respectively, its management) was aware at the time of the transaction that the company was already in financial distress.

4.3 Heads of challenge and requirements to set aside transactions vulnerable to attack under non-bankruptcy specific regulations

Unauthorised related-party transactions

4.3.1 (a) Please refer to sections 1.3.4 to 1.3.6 above.

(b) There is no specific defence available to the counterparty. It is irrelevant whether the related party was unaware that the transaction was not authorised. The comments on bona fide third parties under section 4.2.1(b) equally apply.

Transactions that are "ultra vires" for the company

4.3.2 (a) Please refer to sections 1.3.7 and 1.3.8 above.

(b) There is no specific defence available to the counterparty. It is irrelevant whether the related party was unaware that the transaction was not within the permitted scope of activities. The comments on bona fide third parties under section 4.2.1(b) equally apply.

Transactions beyond the scope of authority of the legal representative

4.3.3 (a) Please refer to sections 1.3.9 and 1.3.10 above.

[35] Article 138.1 of the Civil Code.
[36] Article 138.2 of the Civil Code.
[37] Article 43.1(b) of the Law on Bankruptcy.
[38] Article 138.1 of the Civil Code.
[39] Article 43.1(c) of the Law on Bankruptcy.
[40] Article 43.1(d) of the Law on Bankruptcy.
[41] Article 43.1(dd) of the Law on Bankruptcy.

(b) There is no specific defence available to the counterparty. It is irrelevant whether the counterparty was unaware that the transaction was not within the permitted scope of authorisation of the legal representative. The comments on bona fide third parties under section 4.2.1(b) equally apply. However, the counterparty may have recourse to damages directly against the legal representative[42].

Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company

4.3.4 (a) Please refer to sections 1.3.11 and 1.3.12 above.

(b) There is no specific defence available to the counterparty. It is irrelevant whether the counterparty was unaware that the transaction was not within the permitted scope of authorisation of the person claiming to act on behalf of the company. The comments on bona fide third parties under section 4.2.1(b) equally apply. However, the counterparty may have recourse for damages directly against the person claiming to represent the company[43].

Unlawful distribution of dividends/profits and unlawful payments for the redemption of shares or capital contributions

4.3.5 (a) Please refer to sections 1.3.13 to 1.3.15 above.

(b) There is no specific defence available to the shareholder/member. It is irrelevant whether the shareholder/member was unaware that the distribution of dividends/redemption of shares / capital was unlawful.

QUESTION 5

5. Enforcement

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

5.1 Civil proceedings

5.1.1 When the bankruptcy judge has decided to formally commence bankruptcy proceedings (see section 1.1.2 above), the court also appoints a liquidation committee to manage the company and liquidate its assets during the proceedings[44]. The liquidation committee supersedes the former management whose authority to manage or decide on the affairs of the company ceases upon the appointment of the liquidation committee.

5.1.2 In addition to the liquidation committee, creditors of the company have certain additional rights under the Law on Bankruptcy to protect their positions and ensure their involvement in the bankruptcy proceedings.

Clawback provisions under the Law on Bankruptcy

5.1.3 Applications to the bankruptcy court to declare a voidable transaction void under the Law on Bankruptcy may be made by either any unsecured creditor (including partly secured creditors) or the liquidation committee[45].

Transactions vulnerable to attack under non-bankruptcy specific regulations

	Legal basis	**Person able to commence proceedings**
(a)	Unauthorized related-party transactions	liquidation committee, related party (counterparty); it is not clear whether (but may be arguable that) unsecured creditors may also bring proceedings
(b)	Transactions that are “ultra vires” for the company	liquidation committee, counterparty; it is not clear whether (but may be arguable that) unsecured creditors may also bring proceedings
(c)	Transactions beyond the scope of authority of the legal representative	liquidation committee, counterparty; it is not clear whether (but may be arguable that) unsecured creditors may also bring proceedings
(d)	Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company	liquidation committee, counterparty; it is not clear whether (but may be arguable that) unsecured creditors may also bring proceedings
(e)	Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions	liquidation committee it is not clear whether (but may be arguable that) unsecured creditors may also bring proceedings

[42] Articles 145 and 146 of the Civil Code.
[43] Articles 145 and 146 of the Civil Code.
[44] Article 9.1 Law on Bankruptcy.
[45] Article 44.1 of the Law on Bankruptcy.

5.2 Administrative proceedings

Failure to file a petition to commence bankruptcy proceedings

5.2.1 The administrative fine may be applied by the bankruptcy court and, in special cases, also by the head of the liquidation committee[46].

Falsification of accounting records

5.2.2 Local people's committees (administrative agencies at the level where the company is registered and head-quartered) may apply the administrative penalty[47].

5.3 Criminal proceedings

Criminal matters may involve the police (for investigation), the People's Procuracy (for prosecution) and the court (for trial).

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 Orders available to the civil courts

	Offence	Orders available to the domestic court
(a)	Unauthorised related-party transactions	Bankruptcy court may order that the director (together with the related party) is fully liable (jointly and severally) to the company for damages or may apportion that liability.
(b)	Transactions that are "ultra vires" for the company	See section 6.1(f) below.
(c)	Transactions beyond the scope of authority of the legal representative	See section 6.1(f) below.
(e)	Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions	Bankruptcy court may order that the members of the board of management of the JSC (together with the shareholders) are fully liable (jointly and severally) to the company to the lower of the amount that has been distributed and the debt of the company that cannot be serviced as a consequence of the distribution.
(f)	Breach of labour contract / service agreement	Bankruptcy court may order that the director is fully liable to the company for damages. Where more than one director has acted in concert with another (or has failed to act), they would be jointly and severally liable to the company.
(g)	Breach of other director's duties	See section 6.1(f) above.

[46] Articles 20, and 21 of Decree 10.
[47] Article 21 of Decree 185.

6.2 Orders available to the criminal courts

	Offence	Orders available to the domestic court	
(a)	Transactions in fraud of creditors, Article 130 Criminal Code	Imprisonment:	
		Value of the property	**Term of imprisonment**
		VND 2 mn (USD 100) up to but not including VND 50 mn (USD 2,500)	6 months to 3 years (or non-custodial reform of up to 3 years)
		VND 50 mn (USD 2,500) up to but not including VND 200 mn (USD 10,000)	2 years to 7 years
		VND 200 mn (USD 10,000) up to but not including VND 500 mn (USD 25,000)	7 years to 15 years
		VND 500 mn (USD 25,000) or more	12 years to 20 years, imprisonment for life
		The criminal court may also issue a fine of between VND 10 mn (USD 500) and to VND 100 mn (USD 5,000), declare the confiscation of part or whole of the convicted person's property, issue a ban from holding certain posts and practicing certain occupations or performing certain jobs for a period of 1 to 5 years; In addition, the criminal court may order full civil restitution of the defrauded person or company.	
(b)	Transactions in fraud of consumers, Article 162 Criminal Code	Imprisonment:	
		Value of the property	**Term of imprisonment**
		VND 5 mn (USD 250) up to but not including VND 50 mn (USD 2,500)	3 months to 3 years (or non-custodial reform of up to 3 years)
		"large illicit profits"	2 years to 7 years
		The criminal court may also issue a fine of between VND 3 mn (USD 150) and VND 30 mn (USD 1,500); In addition, the criminal court may order full civil restitution of the defrauded consumer.	

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

Obligation to provide data or present documents upon filing a petition for bankruptcy

7.1.1 The bankruptcy court may require data and information from the person (such as the legal representative) who has filed an application for bankruptcy in order to evaluate whether the company has indeed become bankrupt. Under Article 10.1 of Decree 10, the court may apply a fine of between VND 500,000 (USD 25) and VND 1 mn (USD 50) to the person who has filed the petition but does not comply with the request by the court to provide such data or documents. The same applies where such information is not provided promptly within the time limit determined by the court in the request or where the information is incomplete. In addition to a fine, the court may order a decision to handover to the court known data or information.

7.1.2 The data and documentation that may be requested relates to the information that is required by the court to make an assessment of whether the company is insolvent and can relate to the items that are required to be included in the bankruptcy filing, including (without limitation)[48]:

(a) the operational status of the company and its business, including the grounds for insolvency;

(b) measures that have been taken by the company to remedy its inability to pay its debts;

(c) a detailed list of assets including their location;

(d) a list of creditors, their claims and the status of their claims (unsecured / secured);

(e) a list of debtors, claims by the company against them and their status (unsecured/secured); and

(f) other information and data that the court deems relevant.

Obligation to provide data or present documents after acceptance of jurisdiction by the court

7.1.3 The bankruptcy court may also require the legal representative of the company to provide data and information relating to the items set out in section 7.1.2 above. Under Article 10.2 of Decree 10, the court may impose a fine of between VND 500,000 (USD 25) and VND 1 mn (USD 50) on the legal representative in the event that the legal representative does not comply with the court's request. In addition to a fine, the court may order a decision to handover to the court known data or information.

Extent of the obligation

7.1.4 The obligation is, as such, not limited to data and information which would not incriminate the legal representative (or other person filing the application for bankruptcy).

7.1.5 Neither the Vietnamese constitution, nor the Criminal Code nor the Criminal Proceedings Code explicitly entitle an accused person to refuse to co-operate with orders of the court or State agencies on the basis that such person may incriminate himself (please see further discussion on this point under section 7.2 below).

7.2 Human rights

7.2.1 Vietnam's Constitution includes a section[49] on, and a commitment by the State to protect, certain basic human rights. The Constitution provides that:

"Article 71
Citizens have the right to physical inviolability and to have their lives, health, honour and dignity protected by law. No citizen may be arrested without a warrant from the People's Court or a warrant from or ratification by the People's Inspectorate except where he or she is caught in flagrant violation of the law.

Arrest and detention must be in accordance with the law. All forms of coercion, humiliation and violation of a citizen's honour and dignity are strictly prohibited.

Article 72
No citizen shall be considered guilty and liable to punishment until a verdict has been reached by the Court and has come into effect.

Citizens who are arrested, detained, brought to court and sentenced unlawfully are entitled to damage compensation and to rehabilitation of their honour. Anyone who in arresting, detaining, prosecuting or sentencing someone unlawfully causes damage to others must be sanctioned by law."

7.2.2 In addition, Vietnam signed the ASEAN Human Rights Declaration in November 2012. Article 20 of the ASEAN Human Rights Declaration provides that:

"20. (1) Every person charged with a criminal offence shall be presumed innocent until proven guilty according to law in a fair and public trial, by a competent, independent and impartial tribunal, at which the accused is guaranteed the right to defence.

(2) No person shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence, under national or international law, at the time when it was committed and no person shall suffer greater punishment for an offence than was prescribed by law at the time it was committed.

(3) No person shall be liable to be tried or punished again for an offence for which he or she has already been finally convicted or acquitted in accordance with the law and penal procedure of each ASEAN Member State."

7.2.3 While the Constitution and the ASEAN Human Rights Declaration recognise the right to due process of law and a number of judicial basic rights relating to criminal proceedings, their provisions are not clear on whether these include a person's right not to incriminate himself. In particular, it is debatable whether the ASEAN Human Rights Declaration includes a person's right not to incriminate himself and the right to silence where the provision of information or the giving of statements would risk that person becoming subject to, or providing evidence against himself, in criminal proceedings[50].

48 Under Article 15.4 of the Law on Bankruptcy.
49 Articles 49 to 82 of the Constitution.
50 See, for example, commentary on page 13 of the Joint Submission to the ASEAN Intergovernmental Commission on Human Rights on the ASEAN Human Rights Declaration dated 12 September 2012 by Civil Society Organisations and people's movements participating in the Civil Society Forum on ASEAN Human Rights Declaration, 10-11 September 2012, requesting clarification on this issue in Article 20 of the ASEAN Human Rights Declaration. On the contrary, the Expert's Note issued by the Rule of Law Initiative of the American Bar Association on the ASEAN Human Rights Declaration dated May 2012 appears to suggest that Article 20 of the ASEAN Human Rights Declaration as well as the Vietnamese Constitution already include such right to "remain silent" (see page 15).

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 statute of limitation for commencing criminal proceedings is:

(a) five years for "less serious crimes" (which carry a maximum term of imprisonment of 3 years);

(b) ten years for "serious crimes" (which carry a maximum term of imprisonment of up to 7 years); and

(c) 15 years for "very serious crimes" (which carry a maximum term of imprisonment of up to 15 years),

and typically commences from the time when the crime has been committed[51].

8.1.2 Accordingly, depending on the value of the fraud, the limitation period for transactions in fraud of creditors under Article 130 Criminal Code may range from 5 to 15 years (see section 6.2 above). The limitation period for transactions in fraud of consumers under Article 162 Criminal Code may be five years or ten years (see section 6.2 above).

Limitation period for administrative actions

8.1.3 The statute of limitation for bankruptcy-related administrative penalties is one year from the date on which the offence was committed[52]. However, under Decree 10, measures to remedy the consequences of the breach may still be applied (e.g. documents and information may still be requested and, if not provided, the request may be enforced) after such period.

Limitation period for civil actions

8.1.4 The limitation period for initiating legal action in relation to claims for damages is two years[53]. A two-year limitation period also applies to breaches of a contractual obligation[54]. This would apply, for example, to breaches of contractual duties of directors under labour contracts or service agreements[55].

8.1.5 The limitation period commences from the day when the civil rights or interests of the affected party are infringed[56].

8.2 Appeals

Appeals in criminal proceedings

8.2.1 Judgments and decisions issued by the criminal court of first instance (typically the district-level people's court for the offences outlined above, unless the offender is a foreign national, in which case the provincial-level people's court would have jurisdiction over the matter) may be appealed[57]. The higher court (the court of appeal at the provincial-level people's court for appeals against judgments and decisions from the district-level people's court and the court of appeal of the Supreme People's Court for appeals against judgments and decisions of the provincial-level people's court) will typically review both the facts and the application of the law by the lower-level court. The appellate court may also extend the review beyond the part of the judgment or decision against which the appeal is directed[58].

Appeals in administrative proceedings

8.2.2 A director or other addressee of an administrative sanction issued by the bankruptcy court may lodge a complaint against the administrative decision with the bankruptcy court for self-review and, if the administrative decision is not amended, with the appellate court. Where the administrative decision is issued by the head of the liquidation committee, it would be subject to review by the bankruptcy court, if challenged.

Appeals in civil proceedings

8.2.3 Judgments and decisions issued by the civil court of first instance (typically[59] the provincial-level people's court would have jurisdiction over the matter) may be appealed[60]. The review of the higher court in civil matters (the court of appeal of the Supreme People's Court for appeals against judgments and decisions of the economic court at the provincial-level people's court) comprises, as in criminal matters, both the facts and the application of the law by the lower-level court.

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[51] Article 23 of the Criminal Code. The limitation period may be stayed in certain cases, e.g. where the offender has left the country.
[52] Article 5 of Decree 10.
[53] Article 607 of the Civil Code.
[54] Article 427 of the Civil Code.
[55] The new labour code of Vietnam which will come into effect on 1 May 2013 may shorten the limitation period for certain of these claims to between 6 months and 12 months, Article 202 of the new Labour Code.
[56] Article 159.1 of the Civil Code.
[57] Article 20 of the Criminal Procedure Code.
[58] Article 241 of the Criminal Procedure Code.
[59] Where the dispute is solely based on a breach of the director's labour contract, the labour courts would have jurisdiction.
[60] Article 242 of the Civil Procedure Code.

QUESTION 9

9. Foreign corporations

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

9.1 Vietnamese law only recognises enterprises established and registered under Vietnamese law as being domiciled in Vietnam[61]. The bankruptcy regulations therefore only apply to Vietnamese enterprises and co-operatives. These may include purely domestic Vietnamese companies, as well as enterprises or SOEs which have received foreign investment. The scope of application of the Law on Bankruptcy would not extend to foreign corporations.

9.2 Criminal liability under Vietnamese law, however, applies only to natural persons, including foreign nationals (acting for foreign companies or for Vietnamese companies) in the territory in Vietnam. It is therefore possible that foreign nationals (or Vietnamese nationals acting as directors for foreign companies in Vietnam), may be prosecuted for the criminal offences set out under section 2 above.

9.3 The above also does not exclude that foreign companies may become involved in Vietnamese bankruptcy proceedings as, for example, creditors, debtors or counterparties to a voidable transaction.

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 to 9 above?

10.1 As with the concept of directors' and officers' liability, D&O insurance is only gradually taking hold in Vietnam. Previously, mainly companies with foreign investment provided D&O insurance coverage for their management personnel in Vietnam with the insurance policies being part of a regional D&O insurance arrangement and underwritten by international insurers rather than Vietnamese insurers. Since roughly 2004/2005, Vietnamese insurers have commenced offering D&O insurance coverage directly to domestic and foreign-invested enterprises in Vietnam. Despite this, it is not yet common for domestic Vietnamese enterprises to take out D&O insurance coverage for their directors and senior management personnel. D&O insurance typically excludes wilful and intentional breaches by the director.

10.2 For listed and public JSCs, Article 13.6 of Circular 121 provides that:

"A public company may purchase liability insurance for members of the board of management after obtaining approval from the general meeting of shareholders. Such insurance shall not include insurance for liabilities of members of the board of management in relation to any breach of law and the company charter."

For these JSCs, the approval by the general meeting of shareholders is therefore required before any D&O insurance may be obtained by the company for its directors.

10.3 Vietnamese law does not apply any mandatory minimum deductible for D&O insurance coverage (as is, for example, the case under the German law on joint stock companies for members of the board of directors of joint stock companies).

10.4 There is no general statutory indemnification of a director who is held liable by the company or third parties. However, the company and its director may agree on specific details of the director's appointment in the director's labour contract, appointment letter or service contract. It is common for the company and the director to agree that the director is to be indemnified by the company if held liable by third parties for debts or obligations that were initially those of the company (although in an insolvency situation, the indemnity would provide limited protection to the director). Article 13.6 of Circular 121 currently only limits the extent to which such an indemnity may be agreed for members of the board of management of public or listed JSCs. It remains to be seen whether these restrictions will be extended to D&O coverage that may be provided to other directors of public or listed JSCs and/or of other company form.

[61] Section I.1. of Resolution No. 03.

QUESTION 11

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

11.1 Risks for directors

11.1.1 The key risks for directors acting during the twilight period are set out under questions 1 and 2 above. Under Vietnamese (bankruptcy) law generally, the obligations and duties of the director owed to the company do not change during the twilight period such that the director would have to have additional regard to the safety of creditors once the director becomes aware of the distressed financial situation that the company is in.

11.1.2 However, in certain circumstances there is a risk that a director would become criminally liable in the event that the transaction includes the appropriation of property through fraud under Article 139 of the Criminal Code. The details as to what obligations a director has vis-à-vis the company's (new) creditors remain largely unclear, in particular whether a director would have to disclose certain information on the delicate financial health to the counterparty. However, if the counterparty requests particular information or a review of documents (e.g. as part of a due diligence review of the borrower), information that is provided would have to be complete and truthful to avoid criminal liability under Article 139 of the Criminal Code.

11.1.3 A transaction in fraud of creditors must be committed with intent in order for it to qualify as a crime. Pursuant to Article 9 of the Criminal Code, a person acts with criminal intent where either the person is aware that their "acts are dangerous to society, foresee the consequences of such acts and wish such consequences to occur" or, alternatively, where the offender does "not wish, but consciously allows, such consequences to occur".

11.2 Risks for counterparties

11.2.1 The risks for unrelated third parties that enter into transactions during the twilight period are discussed under question 3 above. However, it is important to note that providing new credit under a balanced transaction (which does not include any of the preferences or other factors that would make the transaction voidable) would not be subject to attack if entered into during the twilight period. This would also be the case where the transaction is secured and the security is provided for new credit.

11.2.2 Where the counterparty providing new or additional credit is aware of the distressed situation that the borrower is in, however, it would typically require more comfort and, accordingly, a higher degree of security than would be the case when dealing with non-distressed companies. There may then be certain risks that such a transaction would later be looked at as voidable if it is determined that the primary objective was not to extend new credit but rather to dispose of assets of the distressed company in favour of the creditor.

11.2.3 Where the counterparty is not aware of the special circumstances that the borrower is in, its protection is extremely limited and any counterparty will have to carefully evaluate the commercial risks of a transaction with another company (which encounters further difficulty because, in Vietnam, credit ratings and independent credit checks are not generally available and the quality of financial statements is limited).

11.2.4 Ultimately, this also puts borrowers at a disadvantage as companies (in particular banks) may be more reluctant to provide essential credit to a distressed company that may well have been in a position to recover if the banks decide not to take on these risks for lack of protection provided to them under the bankruptcy laws.

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