INSOL INTERNATIONAL

DIRECTORS IN THE TWILIGHT ZONE

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INTERNATIONAL FEDERATION OF INSOLVENCY PROFESSIONALS

Directors in the Twilight Zone

Sponsored by Gordon Brothers

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The concept of the limited liability company and the clear distinction between the assets of the company and those of its proprietors, is one of the pillars of economic development. This limits the creditor's rights on a corporate failure to recovering their claim from the assets of the company. It is essential that this protection extends not only to the proprietors but also to the management and officers of the company. If however, this protection was without limits, it would encourage reckless economic activity. Most jurisdictions therefore seek to balance the "carrot" of limited liability with the "stick" by limiting the protection offered to directors and third parties where they have been deficient in their duties - but with widely differing effectiveness.

At no time is the need for effective corporate stewardship greater than in the period immediately prior to a corporate collapse – the Twilight Zone of Insolvency.

INSOL International has undertaken a world-wide survey of the risks run by directors, managers and third parties in the Twilight Zone and we have great pleasure in presenting the results of this survey to the membership. The team that produced this work, led by Gordon Stewart of Allen & Overy, London, is to be congratulated on completing the work in a form that is useable and useful.

The issue of effective corporate stewardship is of considerable importance to the development of many emerging and developing economies and we hope that this publication will be of assistance to those responsible for the development of their economic and regulatory regimes.

Neil Cooper
President
INSOL International

Foreword & Acknowledgement

Gordon Stewart, Allen & Overy

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

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

We formed a committee of INSOL members to co-ordinate the task of production, split for ease of administration on north/south time zone lines:

Geographical Area	*Committee Members*	*Jurisdiction Responsibility*
Americas	Geoff Morawetz *(Goodmans LLP, Toronto)* Angela Pollard *(Pollard & Associates, Richmond Hill, Ontario)* James Lukenda *(Andersen, New York)*	Argentina Canada Mexico United States
Australasia and **Asia**	Peter Agardy *(Cornwall Stoddart, Melbourne)* Mike Whale *(Lowndes Associates, Auckland)*	Australia China India New Zealand
EMEA	Gordon Stewart *(Chairman)* *(Allen & Overy, London)* Sijmen de Ranitz *(De Brauw Blackstone Westbroek, Amsterdam)* Jan van Apeldoorn *(Amsterdam)*	England Egypt France Germany The Netherlands

There were many, many other countries we would have liked to have included but it seemed to us important to ensure that we did not over-extend ourselves and further it occurred to us that the project could be taken to a second stage and involve other jurisdictions in the future.

Our aim was not to produce a legal treatise on directors' duties in our chosen jurisdictions. Further, the factual situation of any company will have a huge impact on the advice professionals give to its directors. What we did was produce 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) - and answer these questions for each jurisdiction. Our vision was of the INSOL member rushing to catch a flight to an unfamiliar jurisdiction, grabbing our book and using our question and answer system to orientate him or herself in respect of the regime they were about to encounter so that they knew in general terms the pressures (if any) being felt by the various players in the drama. We hope INSOL members find it useful.

Some major expressions of gratitude are necessary. Thank you to the committee members listed above who all involved themselves enthusiastically in the project and participated in telephone conference calls at 12.00 noon GMT which of necessity therefore involved an early start to the day in the Americas and a late finish in the antipodes. Thank you indeed to the contributors of the material set out below - without their hard work and dedication we would literally have had no work product. Thank you to Neil Cooper, President of INSOL, for his personal support for the project at all stages. And in the case of the English submission, my personal thanks to Professor Len Sealy of Gonville and Caius College, Cambridge, who kindly read our final draft and made a number of helpful suggestions for improvement.

Finally, my heartfelt thanks to my colleagues Rob Westwater and Jill Johnston who helped me write the English version and, in the case of Rob, who shouldered the main burden of organisation and of driving the project forward.

Each contributor has stated his/her view of the position in his or her jurisdiction as at 1st June, 2001.

Gordon Stewart
Allen & Overy, London
June 2001.

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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. The "twilight" period is the time period between the judicially decided date of commencement of insolvency and the judicial pronouncement of a bankruptcy or liquidation proceeding (defined by Argentina Bankruptcy Law 24.522, ABL 116).

1.2. The legal limit of that period is two years prior to: (a) the pronouncement of the bankruptcy or liquidation proceeding; or, (b) the filing by the debtor of a previous frustrated reorganisation proceeding ("*concurso preventivo*") (ABL 116), is set for challenging the following acts (ABL 118 and 119):

a. Gratuitous acts;

b. Prepayment of debts not otherwise payable until the day of judicial pronouncement of bankruptcy or after this date;

c. Granting security of any kind to secure an undue obligation;

d. Acts causing damage to the creditors, concluded during the "twilight" period where an agent is aware of the impending bankruptcy.

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

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

2.2. For transactions entered into by the corporation during the "twilight" period, personal liability on the part of directors or officers may not be raised by creditors unless a formal insolvent liquidation – and not a reorganisation – procedure follows. Nevertheless, the director may be liable for claims by individual creditors on the grounds of damages suffered to his/her personal estate (Argentina's Corporation Law, 59).

2.3. However, shareholders may challenge transactions entered during that period, and this might give rise to personal liability on the part of directors, irrespective of whether or not formal proceedings are instituted.

3. Does it depend on the nature of the transaction?

3.1. The objective of insolvency remedies is to ensure fair (traditionally expressed as "equal") treatment to all stakeholders. Accordingly, the transactions concluded during the "twilight" period which are of the nature described in *1.2.a.* to *d.* are vulnerable to attacks by creditors.

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

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.

4.2. Nevertheless, the relationship between the party and the company has significance in the determination of personal liability by the party in cases of control.

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

5.1. The "twilight" period is extended under two circumstances:

5.2. When the liquidation proceeding follows a frustrated reorganisation proceeding, the two year limit (ABL. 116) starts to run from the filing of the petition of the reorganisation proceeding.

5.3. When considering the personal liability of directors or officers to creditors (ABL 173), the "twilight" period is extended to one year prior to the date of judicial pronouncement of insolvency (ABL 174).

QUESTION 2

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2. Actions potentially giving rise to liability for directors

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

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

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

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

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

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

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

1. *General fiduciary duties*

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

1.2. ACL 59 Is designed so that directors focus on the best interests of the company and shareholders. However, the restriction in the company's administration that permits the company to undertake reorganisation proceedings (ABL 15 to 17), presumes that the directors comply with the fair treatment of the creditors rule.

2. *Liability under Argentina's Bankruptcy Law 24.452 (ABL)*

2.1 In the case of a company under reorganisation proceedings, failure to comply with 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 his/her estate (ABL 17). Consequently, directors may be held liable for such actions.

2.2. A director or officer may be held personally liable for acts occurred during the "twilight" period (see 1.5.3).for deliberately producing, facilitating, permitting or aggravating the patrimonial situation of the company or its insolvency. The quantum of liability is to recover the damages caused by the director (ABL 173, first part). The action should be brought by the *síndico* (judicially appointed trustee) within two years of the judicial pronouncement of bankruptcy (ABL 174).

2.3. A director or officer may also be found personally liable for acts during the "twilight" period – or after the declaration of bankruptcy when knowingly participating in acts which have the effect of diminishing the assets or exaggerating the debts of the company. (ABL 173, second part) The action should be brought by the *síndico* within two years of the judicial pronouncement of bankruptcy. (ABL 174) The extent of such liability is:

a. the restitution of the goods still under his power;

b. the obligation to cover the damages caused; and,

c. the loss of any right to claim against the bankruptcy estate. (ABL 173, second part)

2.4. ABL 161 refers to the liability for abuses committed by a controlling person. The sanction is the extension of insolvency proceedings to include the controlling party's own bankruptcy. The provision does not mention the controller's directors as liable under it. Nevertheless, liability may be found on these grounds, and the bankruptcy may be extended by the Court to include the director's estate regardless of his/her personal solvency.

3. Liability under Argentina's Corporation Law 19.550 (ACL)

3.1. ACL establishes different actions that may render a director liable for corporate wrongdoing. These actions, described in ACL 276, 277 to 279, are generic liability actions, thus making applicable the rules of the law of restitution. They may be exercised regardless of the existence of insolvency proceedings. The rule is that all directors are jointly and several liability (*ilimitada y solidariamente*) are liable to the corporation, shareholders, and third parties, for:

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

b. any violation of the law, articles of incorporation or bylaws; (ACL 274) and,

c. any other damage produced deliberately or by the abuse of their position. (ACL 274)

3.2. The enumeration and basic description of these actions is as follows:

a. ACL 276, first part, describes the action to be taken to pursue the liability of one or more directors to the corporation. It presupposes a detriment to the company's patrimony or estate and it must be approved at a corporation's meeting. Such a decision implies the automatic removal of the director from his position and requires the naming of a substitute. In a liquidation, the *síndico* may continue the action (ACL 278 and ABL 175), or it may also be continued by any interested party, including shareholders (ABL 176 *in fine*).

b. ACL 276, second part, allows the previously mentioned action to be brought by any shareholder who has objected to the approval of the directors' or officers' performance at the shareholders' meeting.

c. ACL 277 allows any shareholder, to file the action described in ACL 276, first part, when there is inaction by the corporation after three months of the decision date. In this case, the shareholder acts in the place of the corporation.

d. ACL 279 states that both shareholders and third parties always have an individual right of action against directors. This right of action is in connection with loss to the estate of the shareholder and does not depend on any previous corporate proceeding. Thus, this action is not affected by any approval of the directors' duty at the shareholder's meeting.

e. ACL 54 refers to the liability for abuse committed by the controlling person. It does not mention the controller's directors as being liable. Nevertheless,

liability may be founded on the general principles of torts, under Argentina's Civil Code art. 1109.

4. Liability under Argentina's Penal Code (APC)

4.1. The APC describes different offences that may be committed by directors in the performance of their duties:

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

b. APC 300, inc. 3, refers to the publication, certification, or authorisation of false or incomplete corporate documents. Punishable by imprisonment, the offence must be deliberate. The legally enumerated documents include balance sheets and Board minutes.

c. APC 300, inc. 3, describes the offence of providing false information or failing to provide adequate information to the company's assembly. Punishable by imprisonment, this offence requires deliberate conduct, regardless of its reason, related to information concerning important facts about the financial position of the corporation.

d. APC 301 describes the deliberate consent or participation of directors or officers for the realisation of acts in violation of the law, articles of incorporation, and bylaws, that may cause damage. Punishable by imprisonment, the sanction is aggravated if the offence involves the issue of stock.

e. APC 176/178 describes the offences of fraudulent bankruptcy and bankruptcy caused by criminal negligence. Punishable by imprisonment, the sanction applies to directors found guilty of co-operation or participation in acts of criminal negligence or fraud causing damage to the estate of the bankrupt company and/or its creditors.

5. Penal liability under other laws

5.1. Different offences of a penal nature are described in specific statutes for other areas of law, the most important being: tax violations described 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?

1. Liability under Argentina's Bankruptcy Law 24.452 (ABL)

1.1. The general rule is that any person involved in corporate affairs may be found liable under ABL 173, second part, to the same extent as a directors' liability described in *question 2,2.3*.

1.2. Any officer or person representing the corporation may be found liable under ABL 173, first part, in the same way as a director. (as described in *question 2.2.2*.)

1.3 A creditor who is aware of the corporation's insolvency at the time of a transaction, during the "twilight" period may not oppose other creditors' rights arising out of that transaction, See *Question 1, 1.2.d.* That transaction is reviewable provided it causes damage to the creditors by harming the insolvent estate. The onus of proving the absence will be on the creditor who knew of the insolvency. (ABL 119).

1.4. The creditor who is aware of the corporation's insolvency during a reorganisation proceeding, who enters into a transaction against the legally established administration rules (ABL 15 to 17) is vulnerable to attack through actions of fraud, or simulation, which are brought under civil law.

2. *Liability under Argentina's Corporation Law 19.550 (ACL)*

2.1 ACL establishes a general rule about corporate officials. For the performance of their duties they may be held liable in the same terms and extension as directors, without excluding the directors' liabilities.

2.2. Accordingly, the applicable corporate rule is that officers are liable to the corporation and third parties, for:

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

b. the violation of the law, constitutional documents; (ACL 274) and,

c. any other damage produced wilfully or in abuse of their powers. (ACL 274)

2.3. The enumeration and general descriptions of actions against directors as in *question 2.3.2.* are applicable under the rule in 2.1. (ABL 270).

2.4. ACL establishes a general rule about the liability of the members of the Supervisory Board. The provisions in ACL 273,274, 275, 276 277, 278 and 279 are applicable to them.

2.5 When the corporation has a private supervisor, different from a board, the supervisor is liable for any breach of law or statutory duties. In addition, they may be held liable together with directors, provided his/her conduct according to law or statute has prevented the damage suffered by the corporation. (ACL 297)

3. Liability under Argentina's Penal Code (APC)

3.1 The conduct described in *question 2,4.1.* is restrictively applicable to other persons involved in the affairs of the corporation. The following restrictions should be noted:

3.2. APL 173, inc. 7, is arguably applied to officers.

3.3. APL 300, first and second parts are applicable to members of the supervisory board and liquidators, and arguably to officers.

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

3.5. APL 176/178 is applicable to directors, members of the supervisory board, managers (*gerente de la sociedad o establecimiento*) and accountants of the corporation.

QUESTION 4

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

(a) From the point of view of a counterpart 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?

1. *General rule*

1.1. The general rule for transactions entered into the company during the "twilight" period is that they may be vulnerable to attack when the transactions impair creditors' interests. (ABL 119)

2. Reviewable transactions

2.1. Some of these transactions are enumerated by law and are voidable (specifically, not valid against other creditors) by the bankruptcy judge without intervention of any party. Rights of appeal exist. The transactions thus enumerated are:

a. Gratuitous acts;

b. Anticipated payment of debts payable the day of judicial pronouncement of bankruptcy or after; and,

c. Setting of a preference of any kind to secure an undue obligations (ABL 118)

2.2. All transactions not included in ABL 118 may be tested under the general rule of ABL 119, as described in *1.1*. (i.e. provided they impair other creditors' interests). Such actions must be brought by the *síndico,* with the previous authorisation of the majority of verified creditors. The bankruptcy judge's decision is subject to appeal by the injured party.

3. Defence

3.1. An effective defence available to the third party is the proof of absence of damage to fellow creditors (ABL 119). Since this provision aims at protecting creditors, and not the bankrupt debtor, their interest is the one at stake.

3.2. There are no stated defences for the transactions mentioned in *2.1*. It should be noted that if the conditions are met, the judge's decision may be taken without any previous proceedings.

QUESTION 5

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5. Enforcement

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

1. *General rules*

1.1 In the event of a company whose insolvent liquidation has been commenced, the authority and powers of the directors are taken over by the *síndico*. Consequently, in most cases, the power to bring actions against directors,

officers, and others identified in *question 3* lays in the hands of *síndico*, who must obtain the authorisation of the majority of the verified creditors to that end.

1.2 In the event of inaction or failure by the *síndico* to seek such an authorisation, a creditor is permitted to bring the action.

1.3 The primary exception to these general rules is with respect to criminal proceedings for the offences detailed in *question 2*.

2. Corporate proceedings

2.1. According to ACL 279, actions against directors, based on ACL 276 and 277, may be brought by the *síndico*, though shareholders and third parties retain their actions for personal damages suffered by them. The same rule is applicable to officers and members of the Supervisory Board.

2.2. ABL 175, second part, prescribes that corporate actions prior to the judicial pronouncement of insolvent liquidation proceeding may continue in front of the bankruptcy judge. In this event, the *síndico* may decide whether to continue the pre-existing proceedings, or to bring an action based on Bankruptcy Law.

3. Bankruptcy proceedings

3.1. As stated in *1.1*, the *síndico* in liquidation proceeding is the party who will bring any 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 comply with the authorisation requirement, referred to in *question 4.2.2.* (ABL 119) for the action to proceed.

3.2. For all cases previously mentioned, in the event of inaction of the *síndico* (ABL 120) or the failure to obtain the required majority (ALB 119), any creditor may bring a legal action to challenge any reviewable transaction or to hold a director, officer, Supervisory Board member, or other liable. The creditor pursuing this action does so at his own expense.

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

3.4. Either the *síndico* or a creditor may bring an action for the extension of liquidation proceeding (ABL 163). Such a petition must be filed after the judicial pronouncement of liquidation within the time limit set by ABL 163. This action may be aimed at:

a. persons acting under the appearance of the bankrupt; (ABL 161, 1)

b. any person controlling the insolvent corporation who has guided its conduct towards interests different from those of the bankrupt; (ABL 161, 2)

c. any person having his/her estate (*patrimonio*) so confused with that of the bankrupt that determination of each person's assets and debts is impossible. (ABL 161, 3)

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)?

1. *General rules*

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

1.2 In case of liquidation proceedings, directors, corporate officials and representatives of the bankrupt company are obliged to co-operate with the *sindico* (office holder) and with the court, to provide information in order to clarify the situation of the estate and/or the debts of the company. The court has power to enforce the duty to co-operate. Any person failing to attend before the court to provide information may be arrested (ABL, 274 inc. 1 and 275 inc. 3).

1.3 In case of reorganisation proceedings, directors failing to provide information required by the court and/or by the *sindico* (office holder) may be removed from office by the court.

2. Limits

2.1. Article 18 of the National Constitution establishes that "no one is obliged to declare against him or herself". Accordingly, in cases of bankruptcy proceedings this constitutional provision may be invoked to refuse to provide any information that could be considered as self-incriminating.

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?

(See: answers to questions 1 and 2)

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

1. *General rule*

1.1 In civil and / or penal proceedings, appeals are always available against decisions of the first court of instance establishing civil responsibilities or criminal liabilities.

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?

1. *General rule*

1.1 ACL 121 establishes that representatives of foreign companies have the same responsibilities and liabilities of directors or administrators 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?

There is no available insurance to provide effective protection to directors against personal liability which may arise in connection with the above mentioned issues.

Notes

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 Law* ("Voidable transactions") deals with those company transactions which are vulnerable to attack during the period preceding formal insolvency. The start and duration of the "twilight" period depends on the nature of the transaction and the identity of the parties to it.

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

(a) Insolvent transaction

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

(b) Unfair preference

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

(c) Uncommercial transactions

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

(d) Unfair loans

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

[1] All references are to the Australian *Corporations Law*. Note that other statutes in Australia also deal with the personal liability of directors (see, eg, s. 325 of the *Co-Operatives Act 1992* (NSW); s. 188 of the *Life Insurance Act 1995* (Cth); s. 52 of the *Occupational Health and Safety Act 1985* (Vic)).
[2] An officer of the company may also contravene s. 596(b) by making a transfer or gift of company property with intent to defraud the company, shareholders or creditors.

(e) Relation-back day

The time period in which transactions are vulnerable to attack is determined by reference to the "relation-back day".[3]
In the majority of cases the relation-back day will be the day upon which the application for the winding up of the company is filed with the court.[4]

1.2 What time frames are involved?

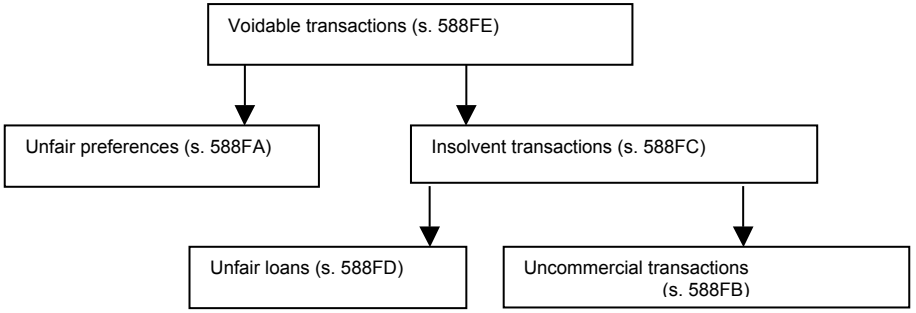
1.2.1 Where a company is being wound up, past transactions may become voidable transactions pursuant to s. 588FE.

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

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

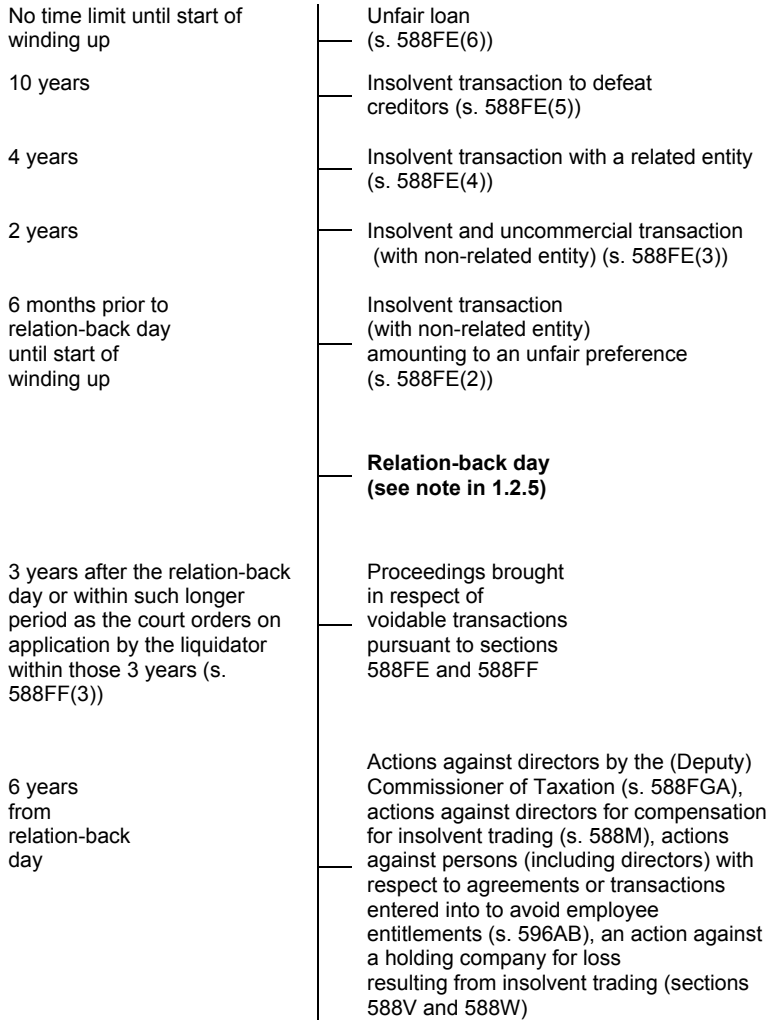
[3] Defined in s. 9.
[4] If the company was in voluntary administration or subject to a deed of company arrangement when the winding up order was made, then the relation-back day will be determined by reference to the day on which the administration began (s. 513C).
[5] The term "related entity" is defined in s. 9, and includes a promoter of the company, a director and a relative or de facto spouse of those persons.

1.2.3 The following diagram[6] illustrates the meaning of "voidable transaction" in the *Corporations Law*.



[6] Layout suggested by Andrew Keay.

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



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

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

1.3 Floating charges

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

QUESTION 2

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

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

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[8] At common law directors may, in addition, owe duties to creditors where the company is insolvent: *Walker v Wimborne* (1976) 137 CLR 1 (but now see *Spies v The Queen* [2000] HCA 43 where the High Court indicated agreement with those commentators who doubt that the court in *Walker v Wimborne* was suggesting that directors owe an independent duty direct to creditors, rather than a mere restriction on the right of shareholders to ratify breaches of the duty owed to the company).
[9] Note that liability for acts (b)-(f) and (h) arises even if the act is performed *outside* the "twilight" period.

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

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

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

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

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

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

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

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

2.2 Liability for insolvent trading under s. 588G

(i) Liability of a director may be:

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

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

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

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

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

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

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

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

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

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

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

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

[18] Possibly in conjunction with a compensation order under s. 588K.
[19] Section 588N states: "An amount recovered in proceedings under section 588M in relation to the incurring of a debt by a company is to be taken into account in working out the amount (if any) recoverable in any other proceedings under that section in relation to the incurring of the debt".
[20] Australian Securities and Investments Commission – the corporate watchdog.
[21] Through the liquidator.

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

(v) The defences available are:[22]

(A) in relation to civil liability under sections 588G(2) and 588M – expecting solvency on reasonable grounds, including reasonable reliance on a qualified person for advice; illness or other good reason preventing director from managing the company at the time; or having reasonably tried to prevent the debt being incurred (s. 588H);

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

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

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

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

2.3 Failing to exercise care and diligence: s. 180

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

Civil penalty proceedings are not to be taken, or are to be dismissed, if criminal proceedings resulted in a conviction: sections 1317M and 1317N. However,

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[22] Note that the "business judgement rule" in s.180(2) does not provide a defence to an insolvent trading claim (see below, n 27 and accompanying text, and note to s. 180(2)).
[23] That is, liability which arises from a contravention of a civil penalty provision of the *Corporations Law* (see above, n 17).
[24] Again, this is not an explicit defence, but the way in which the elements of s. 1317G might not be satisfied. Note that, even if a pecuniary penalty order is not imposed as a result, a compensation order may still be imposed under s. 1317H.
[25] Further, a director who has contravened a civil penalty provision may seek relief from liability if he or she acted honestly and ought fairly to be excused: s. 1317S (see also s. 1318 which provides similar relief, but is not restricted to breaches of civil penalty provisions).
[26] That is, a quasi-penal order.

criminal proceedings may be taken after civil penalty proceedings regardless of outcome: s. 1317P.

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

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

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

(v) The defences available to a director are:

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

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

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

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

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

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

[27] This will occur where the directors have acted in good faith and for a proper purpose, had no material personal interest, properly informed themselves, and had a rational belief that they acted in the interests of the company (s. 180(2) – the "business judgement rule"). Note that this defence is only available in proceedings under s. 180; in particular, it is not a defence to an insolvent trading claim (see note to s. 180(2)).
[28] See above, n 25.
[29] That is, a quasi-penal order.

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

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

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

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

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

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

(i) Liability of a director may be:

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

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

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

(ii) Whether the liquidator or an employee[33] applies, the director is personally liable in respect of the loss suffered by the employee.
Note that s. 596AB is not a civil penalty provision, so ASIC cannot apply for relief.

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

[30] See above, n 25.
[31] A person may incur a liability under s. 596AB and under s. 588G from the one breach, in which case the contraventions of the two provisions are defined as "linked" (sections 9 and 596AB(4)), and no double recovery is possible (see sections 588N and 596AD).
[32] Possibly in conjunction with a compensation order under s. 588K.
[33] Under s. 596AC(3) as permitted by s. 596AF or s. 596AH (and not prevented by s. 596AI).

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

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

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

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

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

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

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

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

(v) The defences available to a director are:

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

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

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

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

2.7 Falsification of books; false and misleading statements and information: sections 1307-1309

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

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

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

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

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

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

(B) acting honestly;

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

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

QUESTION 3

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[37] Sections 182 and 183.

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

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

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

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

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

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

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

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

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

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

3.3 Limitation of liability

3.3.1 Whether liability will be limited to that resulting from involvement with a particular transaction, or relates more generally to the overall loss suffered by creditors, will

[40] That is, their liability will be the same as for a validly appointed director.
[41] Sections 180 – 183 of the *Corporations Law* set out duties of care and diligence (s. 180(1)), good faith (s. 181), use of position (s. 182) and use of information (s. 183). Note that sections 182 and 183 also apply to employees of the company.
[42] Section 588FE provides that certain transactions are voidable (unfair preferences, uncommercial transactions, insolvent transactions and unfair loans to a company).
[43] Section 588FF.

depend upon the particular provision of the *Corporations Law* under consideration.

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

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

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

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

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

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.

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

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

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

QUESTION 4

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

QUESTION 5

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5. Enforcement

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

5.1 The company

5.1.1 Whilst not exclusively relevant to the "twilight" period, the company is the appropriate applicant for any breach of the statutory duties of directors and other officers and employees described in answer to questions 2 and 3 above, or for any breach of the general law duty of directors to exercise their powers in the best interests of the company as a whole. The liquidator has power by reason of s. 477(2)(a) of the *Corporations Law* 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

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

insolvent, near insolvent or of doubtful solvency to exercise their powers having regard to the interests of that company's creditors.[49]

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

5.2 The liquidator

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

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

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

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

5.3 Shareholders

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

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.[55]

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

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

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

5.5 Government or regulatory authorities

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

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

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

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

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

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

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

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

5.5.6 For example, in relation to contraventions of civil penalty provisions, ASIC may apply[58] for a declaration of contravention, a pecuniary penalty order or a compensation order. ASIC may also bring proceedings against those guilty of

[56] Sections 596AF, 596AG, 596AH and 596AI.
[57] See Division 9 of Part VI (sections 222ANA-222AQD) of the Tax Act.
[58] Under s. 1317J.

fraud, negligence, default, breach of duty or breach of trust in relation to the company.[59]

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

QUESTION 6

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6. Remedies: orders available to the domestic court

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

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

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

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

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

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

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

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[59] Section 598. See also definition of "eligible applicant" in s. 9.
[60] Section 1313.
[61] The liquidator must be suing in the name of the company.

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

6.4 ASIC or the Director of Public Prosecutions may lay charges where a criminal offence is alleged. Remedies are generally fines and/or imprisonment.[63]

QUESTION 7

7. Duty to co-operate

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

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

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

7.1.1 Directors and certain other persons connected with the company are required to provide a liquidator with a report as to the company's affairs as at the date of its winding up. That report is, in essence, a listing of the company's assets and liabilities. A further obligation exists to provide such additional information as the liquidator requires by notice in writing given to the relevant persons.[64]

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.[65]

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

[62] Alternatively, where the alleged offence is minor, ASIC may issue (under s. 1313) a penalty notice requiring the alleged offender, within a specified time of at least 21 days, to pay the penalty and (if applicable) stop committing the offence. If the recipient complies with the notice, no criminal proceedings are instituted.
[63] 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.
[64] Section 475.
[65] Section 530A.

upon the examination provisions of the *Corporations Law* which allow a court to summon a person for examination about a company's affairs.[66]

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

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

7.2 Applicable human rights laws

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

7.2.2 Australia is a signatory to the *International Covenant on Civil and Political Rights* ("ICCPR"). Under Article 14.3(g) of the ICCPR, a person charged with a criminal offence shall not "be compelled to testify against himself or to confess guilt". This right may be relied upon by directors under question during investigation of the company. The ICCPR, "while having no force [as law] in the Australian municipal law, nevertheless provides an important influence on the development of the Australian common law".[67]

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

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

7.2.4 The privilege does not apply during ASIC investigations, ie a person cannot rely on it in refusing to provide information or a document. However, where the person claims privilege in respect of any incriminating information or document before providing it to ASIC at the investigation, the information or document is not admissible as evidence against the person in a criminal proceeding or a proceeding for the imposition of a penalty (except for proceedings concerned with the falsity of such information or document).[68]

7.2.5 Similar rules apply in relation to examining a person about a corporation under s. 597. Examinees are obliged to answer any question put to them in the context of such examinations notwithstanding that the answers may

[66] Sections 596A and 596B.
[67] *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477.
[68] 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.

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).[69]

7.2.6 It is settled law in Australia that the privilege is not available to artificial entities such as corporations.[70]

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

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

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

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

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

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

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[69] Note that the protection does not apply in civil proceedings.
[70] See above, n 67. See also s. 1316A.

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

8.1.7 Criminal proceedings may be instituted within 5 years after the alleged offence: s. 1316. Penalty notices for alleged contraventions of minor offences[71] 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 Law* 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 Law* pursuant to which the proceeding is brought. For example, where the relevant section of the *Corporations Law* refers to Court with a capital "C", that Court is defined in the *Corporations Law* (s. 58AA) as meaning any Federal Court, Supreme Court or Family Court (ie superior Court). Where the relevant section of the *Corporations Law* refers to court with a small "c", that court means any court exercising "*the jurisdiction of this jurisdiction*".[72]

8.2.3 If a matter is decided in the Supreme Court of a particular State or Territory, the time limit for any appeal would be governed by the rules of that particular Court. For example, in Queensland a party has 28 days after the date of a Supreme Court decision to file a Notice of Appeal (unless the Court of Appeal orders otherwise).[73]

8.2.4 In the Federal Court, a party has 21 days after the date on which the judgment was pronounced, or alternatively the date on which leave to appeal was granted, or such further time as the Court may allow, to lodge an appeal.[74]

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.[75]

[71] See above, n 63.
[72] Section 58AA(1) of the *Corporations Law* 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.
[73] Rule 748 of the *Uniform Civil Procedure Rules*.
[74] Order 52, Rule 15 of the *Federal Court Rules*.
[75] Section 206G of the *Corporations Law*.

QUESTION 9

9. Foreign corporations

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

9.1 The provisions dealing with transactions in the "twilight" period[76] apply to both foreign and domestic companies.[77]

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).[78]

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

10.2 Companies may pay the premium for policies taken out to cover directors' and officers' liabilities as long as cover is not provided for, among others, the following (other than for legal costs – see below):[79]

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

(b) conduct not in good faith;

[76] This encompasses all the provisions of the *Corporations Law* considered above, but may not necessarily include relevant provisions from other legislation.
[77] See definitions of "corporation" (s. 57A), "company" and "foreign company" (s. 9).
[78] On the other hand, the definition of "company" (within which a foreign company must come in order for the *Corporations Law* to apply to that foreign company) requires that the company be registered or "taken" to be registered. It is unclear what "taken to be registered" means, and unless it encompasses a foreign company that has only applied to be registered, the *Corporations Law* only applies to foreign companies that have already been registered.
[79] Sections 199A and 199B of the *Corporations Law*.

(c) conduct resulting in a pecuniary penalty or compensatory order;[80]

(d) conduct involving improper use of position or information;[81] an

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

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

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

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

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

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

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

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

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

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

11.1.3 In *Sandell v Porter*[82] the High Court of Australia stated that, in determining solvency, courts should take into account the debtor's ability to sell assets or

[80] Such conduct is prohibited by sections 1317G and 1317H of the *Corporations Law*
[81] Such conduct is prohibited by sections 182 and 183 of the *Corporations Law*.

borrow money within a relatively short time period.[83] 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.[84]

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

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

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

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

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

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

(b) interest on such advance;

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

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

(e) interest on an amount so payable.

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[82] (1966) 115 CLR 666.

[83] Note that the *Corporations Law* 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)).

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

APPENDIX

Summary of 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 Law*.

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

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

1.4 Summary of insolvency procedures for corporations

1.4.1 Voluntary administration

If a company is insolvent (ie unable to pay all its debts as and when they fall due), its directors may 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.

Notes

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. Insolvent person is defined in the *Bankruptcy & Insolvency Act* (Canada) (the "BIA") as follows: a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and

(a) who is, for any reason, unable to meet his obligations as they generally become due;

(b) who has ceased paying his current obligations in the ordinary course of business as they generally become due; or

(c) the aggregate of whose property is not, at a fair valuation, sufficient, or if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable the payment of all his obligations due and accruing due.[2]

1.1.2 The "twilight" period will, as a general rule, terminate when formal insolvency procedures are commenced.

1.1.3 The definition of "corporation" in the BIA includes any company or legal person incorporated by or under an Act of Parliament or of any province, and any incorporated company, wherever incorporated, that is authorized to carry on business in Canada or that has an office or property in Canada, but does not include banks, authorized foreign banks within the meaning of section 2 of the *Bank Act*, insurance companies, trust companies, loan companies or railway companies.[3] The excluded entities are administered under the *Winding Up and Restructuring Act* ("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] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. C-44, s. 2(1).
[3] BIA, s. 2(1).

1.1.4 The review period under the BIA revolves around the phrase "date of initial bankruptcy event" which is used throughout the BIA to establish the effective date of bankruptcy in certain transactions. In the case of a voluntary assignment, the date of the initial bankruptcy event is the date of the filing or the making of the assignment. In the case of a proposal, the date of initial bankruptcy event is the date a notice of intention or a proposal is filed. Where there has been a petition for a receiving order the date of the initial bankruptcy event is the date of the filing of the petition. At the termination of the review periods the phrase "date of bankruptcy" as referred to in this paper refers to the date on which the insolvent person becomes bankrupt.

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

1.2.1 Transactions entered into by the corporation during the "twilight" period are vulnerable to attack and can give rise to personal liability on the part of directors and officers irrespective of whether or not formal insolvency proceedings are instituted. The liability of directors and officers is not entirely dependent on the existence of formal insolvency proceedings. Liability is based on a breach of fiduciary duty to the corporation and its stakeholders. However, the tests for reviewing certain transactions during the "twilight" period tend to be more objective than subjective if formal insolvency procedures have been instituted.

1.3 Does it depend on the nature of the transaction?

1.3.1 The objective of an insolvency regime is to ensure fair treatment to all stakeholders who have similar legal rights. There are a variety of different transactions that can be reviewed and the time period for such review varies depending on the nature of the transaction. The review periods are as follows:

(a) settlements under the BIA are void as against the trustee in bankruptcy if the settlement was made in the period beginning 1 year before the initial bankruptcy event and ending on the date that the settler becomes bankrupt. Insolvency is not a precondition to a finding of a settlement during this 1 year review period. However, in order for a settlement to be found in the period greater than 1 year before the initial bankruptcy event and up to 5 years before the initial bankruptcy event, the trustee must demonstrate that at the date of the settlement, the insolvent person was unable to pay all of its debts without the aid of the property in question.[4]

(b) fraudulent preferences under the BIA in favour of a creditor may also be void as against the trustee in bankruptcy. The review period is 3 months before the initial bankruptcy event and ending on the date of bankruptcy, but such period is extended to 1 year in the event of a transaction in favour of someone related to the insolvent person.[5]

(c) a reviewable transaction under the BIA exists where a bankrupt has been involved in a non-arms' length transaction during the period commencing 12 months before the initial bankruptcy event and ending on the date of

[4] BIA, s. 91(1) and (2).
[5] BIA, s. 95 and 96.

bankruptcy.[6] The trustee is entitled to inquire into reviewable transactions for the purpose of determining whether a bankrupt has paid or received, as the case may be, fair market value for the property involved in the transaction. If the consideration given or received is conspicuously greater than or less than fair market value, the Court may grant judgment in favour of the trustee for the difference between the actual consideration given or received and the fair market value of the property involved in the transaction. Pursuant to such a judgment, the trustee may recover from other parties to the transaction and/or any other person being privy to the transaction.

(d) where a corporation has paid a dividend, other than a stock dividend, or redeemed or purchased for cancellation any of the shares of the stock of the corporation within the period commencing on the day that is 1 year before the initial bankruptcy event and ending on the date of bankruptcy, the Court may, on application by the trustee under the BIA, inquire into the transaction to ascertain whether it occurred at a time when the corporation was insolvent or whether it rendered the corporation insolvent.[7] If the transaction occurred at such a time, the Court may give judgment to the trustee against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest, that has not been paid to the corporation, provided that the Court finds that (i) the transaction occurred at a time when the corporation was insolvent or the transaction rendered the corporation insolvent; and (ii) the directors did not have reasonable grounds to believe that the transaction was occurring at a time when the corporation was not insolvent or that the transaction would not render the corporation insolvent.

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 lies on the directors.

A director is protected from the provisions of this section if such director protested against the payment of the dividend or the redemption or purchase for the cancellation of shares of the stock of the corporation. If the trustee is able to fulfil the requirements of the statute, the Court may give judgment to the trustee against a shareholder who is related to one or more of the directors, in the amount of the dividend or redemption or purchase price referred to.

(e) a trustee in bankruptcy can also resort to statutes other than the BIA. The *Fraudulent Conveyances Act*[8] is one such example. This legislation, which is enacted at a provincial level, enables the trustee or other creditors to attack any transaction that was entered into with the intention of defeating, delaying or hindering creditors. The predominant view is that the limitation period to challenge transactions is six years from the time when the plaintiff first became aware of the conveyance.

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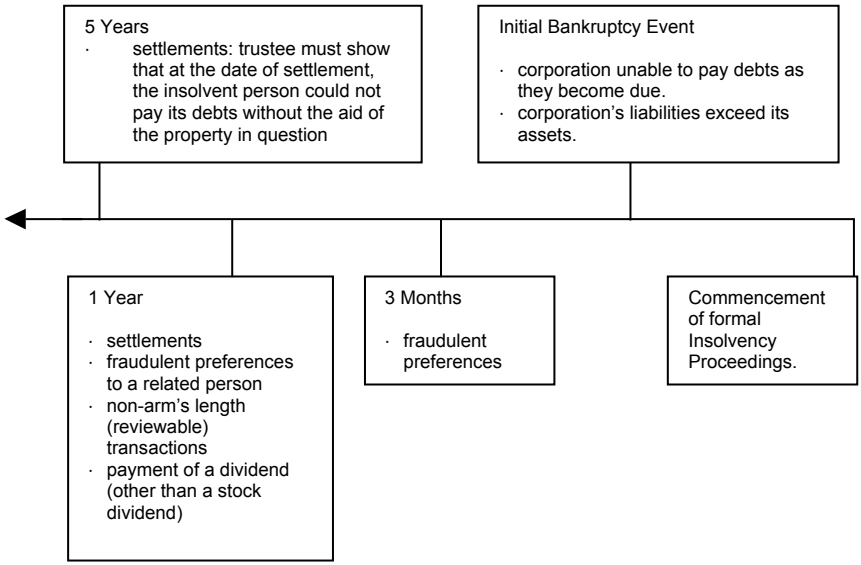
[6] BIA, s. 100(1).
[7] BIA, s. 101(1).
[8] R.S.O. 1990, c. F. 29.

(f) A sale in bulk is voidable unless the buyer has complied with the provisions of the *Bulk Sales Act*.[9] If a sale in bulk has been set aside or declared void and the buyer has taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof.

(g) Although it is beyond the scope of this study, directors are also liable to ensure that certain statutory trust deductions from employee wages are remitted to the governmental taxing authorities. These trusts include income tax, pension plan contributions and employment insurance.



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

1.4.1 The length of the "twilight" period can depend on whether the party to the transaction is (a) related; or (b) dealing at arm's length with the bankrupt. For example, if the parties are related, which generally means a blood relation among individuals or actual control among corporations, then the period in which to review fraudulent preferences is extended from three months to one year.

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

1.5.1 A statutory compromise of the corporation's liability does not in itself relieve a director or officer of their personal liability. However, where the corporation makes the proposal to its creditors under the BIA, the BIA specifically authorizes,

[9] R.S.O. 1990, c. B-14 (the "BSA").

in certain circumstances, the release of claims against directors for liabilities incurred in their capacity as such. A proposal under the BIA or a proposed plan of arrangement under the *Companies' Creditors Arrangement Act* (Canada) ("CCAA") may provide for the compromise of claims against directors if:

(a) the claims do not relate to the creditor's contractual rights against such directors;

(b) the claims are not based on allegations of either misrepresentation, wrongful or oppressive conduct by directors toward creditors; and

(c) the Court determines the compromise to be fair and reasonable in the circumstances.[10]

1.5.2 The legislation does not address compromise of claims against officers. However, recent cases have held that if the plan of arrangement contains or, at least for the corporations' officers, is approved by the various constituencies, it should be viewed as a contract between the debtor and its creditors and should not be interfered with by the Court.[11]

1.5.3 In order to obtain maximum protection, directors usually try to ensure that a proposal under the BIA or a proposed plan of arrangement under the CCAA provides specifically for the release of claims by creditors against them. Such provisions will be effective to the extent permitted by the relevant statute.

QUESTION 2

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2. Actions potentially giving rise to liability for directors

(a) In respect of which acts during the "twilight" period may a director be held personally liable or which may otherwise have adverse consequences for him?
(b) In relation to each act identified in (a) above:

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

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

(iii) will liability attach to individual directors in proportion to their specific involvement?;
(iv) is there a specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and
(v) what defences, if any, will be available in relation to each offence?

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[10] BIA, s. 50(13) and (14); *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, s. 5.1.
[11] *Re Canadian Airlines Corp.* (2000), 20 C.B.R. (4th) 1 (Alta. Q.B.) at 23.

2.1 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:

(i) act honestly and in good faith with the view to the best interests of the corporation; and

(ii) 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, Canadian jurisprudence appears to be following 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.

2.1.3 There may be a fiduciary duty on the part of the directors of a company to act in the best interest of creditors. If the company goes into bankruptcy, the directors may be liable to the bankrupt estate if they should have appreciated or ought to have known that a transaction carried out by the company when it was insolvent, or who's solvency was jeopardized by the transaction, was likely to cause loss to the creditors.[12] Even if lawyers who perform legal work for a company in connection with a transaction do not act purposefully or knowingly participate in the transaction, they may also be liable to the trustee in bankruptcy for their participation in the transaction if they acted recklessly or were wilfully blind to the actions of the company.[13]

2.2 General Bankruptcy Offences under the Bankruptcy and Insolvency Act ("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.[14]

2.2.2 Personal liability will follow where an officer or director:

(a) makes any fraudulent disposition of the bankrupt's property before or after the date of the initial bankruptcy event;
(b) refuses or neglects to answer fully and truthfully all proper questions put to the bankrupt at any examination held pursuant to the BIA;

(c) makes a false entry or knowingly makes a material omission in a statement or accounting;

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[12] *Peoples Department Store Inc. v. Wise*, [1998] Q.J. No. 3571.
[13] *Canbook Distribution Corp. v. Borins* (1999), 45 O.R. (3rd) 565.
[14] BIA, s. 204

(d) after or within 1 year immediately preceding the date of the initial bankruptcy event, conceals, destroys, mutilates, falsifies, makes an omission in or disposes of, or is privy to the concealment, destruction, mutilation, falsification, omission from or disposition of, a book or document affecting or relating to the bankrupt's property or affairs, unless the bankrupt had no intention to conceal the state of the bankrupt's affairs;

(e) after or within 1 year immediately preceding the date of the initial bankruptcy event, obtains any credit or any property by false representations made by the bankrupt or made by any other person to the bankrupt's knowledge;

(f) after or within 1 year immediately preceding the date of the initial bankruptcy event, fraudulently conceals or removes any property of a value of $50 or more or any debt due to or from the bankrupt; or

(g) after or within 1 year immediately preceding the date of the initial bankruptcy event, hypothecates, pawns, pledges or disposes of any property that the bankrupt has obtained on credit and has not paid for, unless in the case of a trader the hypothecation, pawning, pledging or disposing is in the ordinary way of trade and unless the bankrupt had no intent to defraud.[15]

2.2.3 If any of (a) – (g) above are satisfied:

(i) liability is criminal;

(ii) a person guilty of the offence is liable:

(A) on summary conviction, to a fine not exceeding $5000 or to imprisonment for a term not exceeding 1 year, or to both; or

(B) on indictment, to a fine not exceeding $10,000 or to imprisonment for a term not exceeding 3 years, or to both;

(iii) 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);

(iv) the specified period within which the relevant act must have been undertaken in order for liability to attach to a director is described in (a)-(g); and

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

[15] BIA, s. 198(1).

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 which 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.[16]

2.3.2 If 2.3.1 above is satisfied

(i) the liability is criminal. Therefore the answers to (i) to (iii) are as set out in paragraph 2.2.3;

(ii) the impugned transaction must have occurred within the period beginning 2 years before the initial bankruptcy event and ending on the date of bankruptcy; and

(iii) lack of intent to conceal the state of the corporation's affairs amounts to a defence.

2.4 ***Unlawful transactions***

2.4.1 The offence is made out where the director or officer participates in a transaction such that the bankrupt corporation enters into a transaction with any person for the purpose of obtaining a benefit or advantage to which either of them would not be entitled.[17]

2.4.2 Provided 2.4.1 above is satisfied:

(i) liability is criminal;

(ii) the person guilty of the offence is liable on summary conviction, to a fine not exceeding $5,000 or to imprisonment for a term not exceeding 1 year, or to both;

(iii) 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);

(iv) this offence applies after the corporation becomes bankrupt; and

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

[16] BIA, s. 200(1).
[17] BIA, s. 201(3).

2.5 *Declaration of dividends*

2.5.1 Where the court finds that either the bankrupt corporation paid a dividend, other than a stock dividend, or redeemed or purchased for cancellation any of the shares of its capital stock at a time when the corporation was insolvent or the transaction rendered the corporation insolvent, the directors of the corporation are personally liable.[18]

2.5.2 Where 2.5.1 above has occurred:

(i) liability is civil;

(ii) 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;

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

(iv) the declaration of dividends must have occurred within the 1 year period immediately preceding the date of the initial bankruptcy event and ending on the date of the bankruptcy; and

(v) The following defences exist:

(A) the director actively dissented from the resolution authorizing the payment of the dividend; or

(B) 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.[19]

2.6 *Liability for debts due to employees*

2.6.1 According to corporate statutes such as the *Canada Business Corporations Act* ("CBCA"), the directors of a corporation are personally liable to the employees for all debts, not exceeding 6 months wages, for services performed for the corporation.[20] The directors are also liable for any vacation pay that accrued over a period of up to 12 months while they were directors.

2.6.2 Where 2.6.1 above is satisfied:

(i) liability is civil;

(ii) the court may order the directors to pay the debts owed to the employees, with interest at such rate as the court sees fit;

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[18] *Canada Business Corporations Act,* R.S.C. 1985, c. C-44, s. 42; and *Ontario Business Corporations Act,* R.S.O. 1990, c. B. 16, s. 38(3). (Note: Provinces other than Ontario have their own *Business Corporations Act*).
[19] BIA, s. 252.
[20] CBCA, s. 119.

(iii) the directors are jointly and severally liable for the debt;

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

(v) a director is not liable unless:

(A) 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

(B) the corporation has made an assignment or a receiving order has been made against it under the BIA and a claim for the debt has been proved within 6 months after the date of the assignment or receiving order.

It should also be noted that the director is not liable unless he or she is sued while he or she is a director or within 2 years after ceasing to be a director.

2.7 ***Oppression and derivative action***

2.7.1 A complainant may apply to the court for an order under the oppression provisions of the CBCA to rectify the matters complained of if the court is satisfied that in respect of a corporation or any of its affiliates,

(a) any act or omission of the corporation or any of its affiliates effects a result;

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

(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.[21]

2.7.2 Where 2.7.1 above is satisfied:

(i) liability is civil;

(ii) the court may make an order to compensate the aggrieved person;

(iii) 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;

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

(v) if the directors can show that the exercise of their powers was not oppressive or unfairly prejudicial or unfairly disregarded the interests of any security

[21] CBCA, s. 241(2).

holder, creditor, director or officer, then the elements of the offence would not have been established and the action would fail.

2.7.3 The Court may make an interim or final order which it thinks fit including:

(a) an order restraining the conduct complained of;

(b) an order appointing a Receiver or Receiver/Manager;

(c) an order to regulate a corporation's affairs by amending the articles or by-laws or creating or amending a Unanimous Shareholder Agreement;

(d) an order directing an issue or exchange of securities;

(e) an order appointing directors in place of or in addition to all or any of the directors then in office;

(f) an order directing a corporation or any other person, to purchase securities of a security holder;

(g) an order directing a corporation or any other person, to pay a security holder any part of the money paid by the security holder for securities;

(h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(i) an order requiring a corporation, within a time specified by the Court, to produce to the Court or an interested person financial statements or an accounting in such other form as the Court may determine;

(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.[22]

General Liability under the BIA

2.8 *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

[22] OBCA, s. 248(3); CBCA, s. 240(3).

the BIA, make an order directing the person to perform community service, subject to such reasonable conditions as may be specified in the order.[23]

2.9 *Compensation for loss*

2.9.1 Where a person has been convicted of an offence under the BIA and any other person has suffered loss or damage because of the commission of the offence, the court may, at the time sentence is imposed, order the person who has been convicted to pay to the person who has suffered loss or damage or to the trustee of the bankrupt, an amount by way of satisfaction or compensation for loss of or damage to property suffered by that person as a result of the commission of the offence.[24]

QUESTION 3

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

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

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

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

3.1 *Introduction*

3.1.1 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.

3.1.2 In addition, there are a number of transactions committed during the "twilight" period for which third parties who do not control the corporation may be held liable.

3.2 *Reviewable transactions*

3.2.1 If the bankrupt enters into a transaction with a non-arm's length third party, and the consideration for the transaction is "conspicuously greater or less than the fair market value of the property or services", then the court may give judgment to the trustee against any other party to the transaction or against any other party privy

[23] BIA, s. 204.1
[24] BIA, s. 204.3(1).

to the transaction. The party subject to such judgment is required to pay the difference between the actual consideration given or received, as the case may be, by the bankrupt and the fair market value of the property or services.

3.3 ***Fraudulent preferences, settlements and fraudulent conveyances***

3.3.1 The third party may be held liable when an insolvent corporation enters into a transaction with a creditor of the corporation. If the court holds that the transaction was made at a time when the corporation was insolvent with an intention to prefer that creditor over others, then the transaction will be void as against the trustee. The review period is 3 months before the initial bankruptcy event, with an extension to 1 year in the event of related parties. From a practical standpoint, this means that the creditor of the corporation will be obligated to return to the trustee any consideration paid by the bankrupt in the transaction.

3.3.2 Similarly, the recipient of a settlement or the transferee of property in a fraudulent conveyance will also be obligated to return property to the trustee if the transaction is set aside as being a settlement or a fraudulent conveyance.

3.4 ***Liability is not limited to a particular transaction***

3.4.1 Where a person has been convicted of an offence under the BIA, the court may order the convicted person to pay an amount as compensation for the loss or damage to the property to the person who has suffered the loss or to the trustee of the bankrupt.

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 ***Introduction***

4.1.1 There are a number of potential remedies available to creditors and/or the trustee in bankruptcy all of which have at their root the equitable principle that unsecured creditors should be treated equally.

4.1.2 The potential heads of challenge which may lead to transactions being set aside are transactions:

(i) for conspicuously greater or less than fair market value;

(ii) which are preferences;

(iii) which are settlements;

(iv) which are fraudulent conveyances;

(v) which involve dispositions of property after the commencement of bankruptcy proceedings; or

(vi) which do not comply with provincial bulk sales legislation.

4.2 ***Reviewable transactions***[25]

4.2.1 For the purposes of the BIA, a person who has entered into a transaction with another person otherwise than at arm's length shall be deemed to have entered into a reviewable transaction. It is a question of fact whether persons not related to one another within the meaning of the BIA were at the particular time dealing with each other at arms length. Persons who are related within the meaning of the BIA are deemed not to deal with each other at arm's length.

4.2.2 Where a bankrupt has entered into a reviewable transaction in the 1 year period before the initial bankruptcy event and ending on the date of bankruptcy, the court may, on the application of the trustee, inquire into whether the bankrupt gave or received fair market value in consideration for the property or services concerned in the transaction.

4.2.3 Where the court in proceedings under this section finds that the consideration given or received by the bankrupt in the reviewable transaction was conspicuously greater or less than fair market value, the court may give judgment to the trustee against the other party to the transaction, or against any other person being privy to the transaction with the bankrupt, or against all those persons, for the difference between the actual consideration given or received by the bankrupt, and the fair market value as determined by the court, of the property or services concerned in the transaction.

4.2.4 In making an application under this section, the trustee shall state what in his or her opinion was the fair market value of the property or services concerned in the transaction and what in his or her opinion was the value of the actual consideration given or received by the bankrupt in the transaction.

4.2.5 The application of this section of the BIA is subject to 3 conditions:

(a) the transaction must have taken place during the period commencing 1 year before the initial bankruptcy event and ending on the date of bankruptcy;

(b) the transaction must have been at a price manifestly different from fair market value, that is for an inadequate consideration; and

(c) the transaction must be reviewable.

[25] BIA, s. 100.

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 once 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 mandate otherwise.

4.3 *Fraudulent preferences*[26]

4.3.1 By way of overview, a preference arises when an insolvent person enters into a transaction and subsequently becomes bankrupt and the transaction results in a creditor being put in a better position than he or she would have been in if the company had instead gone into liquidation. The attack is made by a trustee in bankruptcy and the courts have the ability to declare the transaction to be fraudulent and void as against the trustee.

4.3.2 The provisions of the BIA with respect to preferences are a means of carrying into effect the principle of the BIA, contained in section 141, that all ordinary creditors should rank equally. Subsection 95(1) makes every conveyance, transfer, charge etc. made by an insolvent person with a view to prefer a creditor within 3 months before the initial bankruptcy event and ending on the date the insolvent person becomes bankrupt, fraudulent and void. Section 96 extends the period to 1 year before the initial bankruptcy event in the case where the creditor is related to the insolvent person.

4.3.3 For the purposes of the BIA, persons are "related persons" if they are:

(a) individuals connected by blood relationship, marriage or adoption;

(b) a corporation and

(i) a person who controls the corporation, if it is controlled by one person,

(ii) a person who is a member of a related group that controls the corporation, or

(iii) any person connected in the manner set out in paragraph (a) to a person described in subparagraph (i) or (ii); or

(c) two corporations

(i) controlled by the same person or group of persons,

[26] BIA, s. 95 and 96.

(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.[27]

4.3.4 For the purposes of the BIA, "relationship" is:

(a) where two corporations are related to the same corporation within the meaning of subsection 4(2), they shall be deemed to be related to each other;

(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.[28]

[27] BIA, s. 4(2).
[28] BIA, s. 4(3).

4.3.5 The BIA states that the intent to prefer is to be presumed, in the absence of evidence to the contrary, if the effect of the conveyance, transfer, charge etc. is to give the creditor a preference over other creditors.[29]

4.3.6 If a payment or other disposition of property is made in circumstances that amount to a fraudulent preference, the transaction remains valid unless or until it is set aside as a fraudulent preference. The mere fact that a creditor obtains a preference is not *ipso facto* proof of a fraudulent intention on the part of the debtor. To constitute a fraudulent preference, there must be both a preference in fact and an intention on the part of the debtor to prefer.

4.3.7 The only kinds of transactions within the time periods referred to in section 95 (see 4.3.2) and section 96 which the BIA protects, are those that take place in the ordinary course of business.

4.3.8 "Fraudulent" in section 95 does not mean actual fraud, but constructive or legal fraud. Constructive fraud is conduct that is characterized as fraudulent by the law, not because it is necessarily *per se* reprehensible, but because it tends to damage the public interest.

4.3.9 To attack a transaction as a fraudulent preference, the trustee must prove that the conveyance was made to a creditor.

Transaction must take place within 3 months (or 1 year if related) before bankruptcy

4.3.10 If the transaction sought to be set aside took place more than 3 months before the initial bankruptcy event (1 year in the case of related parties), resort can be had to the remedies provided by provincial statutes not in conflict with the BIA.

4.3.11 The 3 month or 1 year period is calculated from the date of the initial bankruptcy event and ends on the date that the insolvent person becomes bankrupt.[30] The date of the initial bankruptcy event provides for a dating back and is most important in the case of receiving orders and deemed assignments. In receiving orders, the date of the initial bankruptcy event will be the date of the filing of the petition and the 3 month or 1 year period is calculated from that date. The date when the relevant period ends is the date of the receiving order, assignment, or the date of the event that causes an assignment in bankruptcy to be deemed.

4.3.12 The date for the commencement of the 3 month or 1 year period is the date when the payment was made, the obligation was incurred, or the judicial proceeding was taken, not the date when the intention was formed to make the payment, incur the obligation, or take the judicial proceeding.

Insolvency of debtor

4.3.13 Fraudulent preference remedies can only be invoked if the conveyance was made by an "insolvent person". It is not necessary for the trustee to prove an

[29] BIA, s. 95(2).
[30] BIA, s. 95 and 96.

act of bankruptcy by the debtor, it is only necessary to prove that the debtor was insolvent. The definition of insolvency was set out at the commencement of this questionnaire.

Intention

4.3.14 In order to constitute a fraudulent preference, the conveyance must be entered into "with a view to giving that creditor a preference". The words "with a view to giving that creditor a preference" require only an intention on the part of the debtor. In determining the intention of the debtor, the test is an objective one, not a subjective one (i.e. the intention will be that which the debtor's conduct bears when reasonably construed and not that which, long after the event, he claims was his intention).

The presumption

4.3.15 Under section 95 the trustee is required to prove:

(1) that the conveyance took place within 3 months or 1 year of the initial bankruptcy event;

(2) that the debtor was an insolvent person at the date of the alleged preference; and

(3) that at the date when the conveyance was made, it gave the creditor a preference in fact over other creditors.

4.3.16 When the trustee has proved these three essentials, the conveyance is presumed to have been made with the view to giving a creditor a preference over other creditors.[31]

Defences

4.3.17 The presumption can be rebutted by the defendant to the transaction. If, after considering all the evidence, the court is satisfied that on the balance of probabilities the debtor was pursuing a purpose other than that of favouring the particular creditor over other creditors, the presumption will be displaced and the trustee's application will be dismissed. For example, if the court concludes that a payment was made in the ordinary course of business and not with the intention to prefer, the presumption will have been rebutted and the payment will stand. Payments in the ordinary course of business will ordinarily be made for 1 of 2 reasons:

(a) so that the bankrupt might take advantage of favourable payment terms; or

(b) to secure a continued supply of goods or services from the trade creditor so that the bankrupt could continue in business.

[31] BIA, s. 95(2).

4.3.18 Examples of other defences that can be raised by creditors include that of a diligent creditor continuing to press for payment, security given for present advances, a binding agreement to make payment or to give security made prior to the review period, or where there is no reason to prefer the creditor.

4.4 *Provincial legislation dealing with preferences*

4.4.1 In addition to attacking a transaction under the BIA, it may be possible for a trustee in the common law provinces to make use of provincial acts dealing with fraudulent preferences. The *Assignments and Preferences Act*[32] is ordinarily used by a trustee in bankruptcy when the time limits under section 95 of the BIA have expired. Under the *Assignments and Preferences Act,* 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.[33] Although the wording is different from s. 95 of the BIA, these requirements are substantially similar to those provided by s. 95. However, there are some important differences which generally speaking make it more difficult to prove a preference under the *Assignments and Preferences Act.*

4.5 *Settlements*

4.5.1 Under the BIA, all settlements of property are void if bankruptcy occurs within 1 year after the date of the settlement. Settlements made more than 1 year after but within 5 years of the date of bankruptcy are void where the trustee can demonstrate either that, at the date of the settlement, the settlor was unable to pay all its debts without the aid of the property in question or that the interest of the settlor did not pass on the execution of the settlement.[34]

4.5.2 A settlement, which falls within section 91, is not void but only voidable. It only becomes void when bankruptcy occurs. It is not void as of the date of the making of the conveyance or the date when the court makes the order declaring it to be a settlement, it is the bankruptcy which is the triggering event.

4.5.3 Since 1992, the BIA has provided a partial definition of "settlement". Under this definition "settlement" includes a contract, covenant, transfer, gift and designation of a beneficiary in an insurance contract to the extent that the contract, covenant, transfer, gift or designation is gratuitous or made for merely nominal consideration.[35] Formerly, a settlement did not include a gift. However, as a result of the change in the definition of settlement, settlement now includes a gift.

4.5.4 The trustee does not have to prove a fraudulent intention on the part of the settlor in order to obtain an order setting aside a settlement.

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[32] R.S.O. 1990, c. A. 33.
[33] BIA, s. 4.
[34] BIA, s. 91.
[35] BIA, s. 2.1.

4.5.5 It is important to distinguish between a settlement and a fraudulent preference. A settlement involves a gift to a stranger to the bankruptcy. A preference involves a transaction with a creditor whereby the creditor is preferred over other creditors. The settlement involves the idea of a clear gift or a situation where provision is made for a trust of some sort, it does not include a business transaction between a debtor and a creditor.

Defence

4.5.6 The provisions of section 91 do not apply to any settlement made in favour of a purchaser or incumbrancer in good faith and for valuable consideration. Both elements must be proved in order to come within this exception.

4.6 ***Fraudulent conveyances***

4.6.1 The provincial *Fraudulent Conveyances Act* does not conflict with the BIA, and a trustee in bankruptcy is entitled to make use of such legislation to supplement the rights and remedies provided by the BIA.

4.6.2 The effect of the *Fraudulent Conveyances Act* is that a conveyance that is fraudulent and voided against creditors is not absolutely void but only voidable, the conveyance is good as between the parties to it.

4.6.3 The *Fraudulent Conveyances Act* renders void a conveyance of property made with the intent to defeat, hinder, delay or defraud creditors or others. The act makes an important distinction between voluntary conveyances and conveyances made for good consideration.[36] 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.

4.6.4 Under the *Fraudulent Conveyances Act*, the plaintiff does not have to show that the creditors were in fact delayed, defeated or defrauded, only that the grantor had an intention to defeat, hinder, delay or defraud creditors.

4.6.5 If there is no consideration for a conveyance, it is irrelevant whether or not the grantee had notice or knowledge of the fraudulent intent of the grantor. In the case of a voluntary conveyance, the trustee in bankruptcy need only prove that the grantor had the intent to defeat, hinder, delay or defraud creditors.

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

Defences

4.6.7 The court may not make an order setting aside the transaction if it is satisfied that there was no intent to defeat, hinder, delay or defraud creditors or others.

4.6.8 If the court finds that the conveyance was made with intent to defeat, hinder, delay or defraud creditors, then it is not void if it was made for good consideration

[36] *Fraudulent Conveyances Act*, s. 2.

and bona fide to a person not having at the time of the conveyance notice or knowledge of the intent to defraud.

4.7 *Protection of transaction made in good faith with bankrupt*

4.7.1 The purpose of section 97(1) of the BIA is to deal with the effect of the relation back of the trustee's title in various sections of the BIA, such as section 95 which deals with fraudulent preferences. Section 97(1) applies to payments, conveyances etc. which take place between the date of the initial bankruptcy event and the date of bankruptcy. Four types of transactions as set out in paragraphs (a) – (d) are protected if made in good faith and if they do not constitute a settlement, preference or reviewable transaction. The four headings are:

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

(b) a payment or delivery to the bankrupt;

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

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

4.7.2 With respect to such protected transactions, the law of set-off applies in the same manner and to the same extent as if the bankrupt were the plaintiff or defendant, as the case may be, except insofar as any claim for set-off is affected by the provisions of the BIA respecting frauds or fraudulent preferences.

4.8 Bulk Sales Legislation

4.8.1 *Purpose and Application of BSA*

Although bulk sales legislation has been repealed in most Canadian jurisdictions, it is still applicable in Ontario, Newfoundland and New Brunswick.[37]
Bulk sales legislation was introduced to protect creditors from a secret though valid sale of the debtor's stock and a possible unfair distribution or dissipation of the proceeds of such a sale.

In Ontario, the BSA applies to every "sale in bulk" which is defined as a "sale of stock in bulk out of the usual course of business or trade of the seller" (section 1). "Stock in bulk" is defined as stock which is the subject of a sale in bulk and all other property, real or personal, that together with stock is the subject of a sale in bulk (section 1). "Stock" is defined as:

[37] BSA Ontario; *Bulk Sales Act*, R.S.N.B. 1973, c. B-9; *Bulk Sales Act*, R.S.N. 1990, c. B-11.

(i) goods, wares, merchandise or chattels ordinarily the subject of trade and commerce,

(ii) the goods, wares, merchandise or chattels in which a person trades or that the person produces or that are the output of a business, or

(iii) the fixtures, goods and chattels with which a person carries on a trade or business.

The BSA applies to virtually every sale of stock out of the usual course of business of the seller, subject to certain specific exceptions, such as a sale by a receiver, assignee or trustee for the benefit of creditors, trustee under the *Bankruptcy and Insolvency Act* (Canada), liquidator or official receiver.

The term "sale" includes a transfer, conveyance, barter or exchange but does not include a pledge, charge or mortgage.[38]

4.8.2 *Disclosure of Creditors*

Section 4 of the BSA prohibits the purchaser from delivering a sum more than of 10% of the final purchase price to the vendor until the purchaser has received from the vendor:

(i) 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

(ii) an affidavit verifying that subparagraph (i) 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.[39]

Compliance

In addition to the requirements set out above, one of the following conditions must be met before the purchaser may deliver proceeds of sale to the vendor:

(i) the statement of indebtedness must not disclose total claims in excess of $2,500 by either the secured trade creditors or the unsecured trade creditors (section 8(1)(a)); or

(ii) the vendor must swear an affidavit stating that the claims of all the secured and unsecured trade creditors of the vendor of which the buyer has notice have been paid in full (section 8(1)(b)); or

(iii) adequate provision must be made for the immediate payment in full upon completion of the sale of all unsecured and secured trade creditors except for

[38] BSA, s.1.
[39] BSA, s.5.

any creditor that has signed a waiver allowing the sale to proceed without provision being made to pay its claim in full (section 8(1)(c)); or

(iv) the vendor may deliver to the buyer:

a) a consent from sixty percent (60%) of the unsecured trade creditors of the vendor whose claims exceed $50, and of whose claims the buyer has notice; and

b) an affidavit (of the vendor) deposing that the vendor delivered or caused to be delivered to all secured trade creditors and all unsecured trade creditors, personally or by registered mail, 14 days prior to completion of the sale, a copy of the contract of the sale in bulk, the section 4 statement of indebtedness, a Statement of Affairs summarizing assets, liabilities and contingent liabilities included in the sale in bulk and further deposition that there has not been a material change in the Statement of Affairs since it was made.[40]

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

If one of the conditions outlined in subparagraphs (i), (ii) and (iii) above is met, the buyer may deliver the proceeds of sale to the vendor. If the condition in subparagraph (iv) above is met, the buyer must deliver the proceeds of sale to the person named as trustee in the form of consent, who must then distribute the proceeds of sale among the creditors in an order of priority similar to that which applies to a distribution under the BIA.

Before distribution, the trustee must publish a notice in at least two issues of a newspaper, in the locality where the sale is to take place. In addition, the trustee must wait a minimum of 14 days after last publication before distributing the proceeds of sale.

Completion of Sale

The buyer must file, within five days of the completion of sale, an affidavit setting out the particulars of sale including the subject matter, name and address of any trustee, duplicate originals of the statement of indebtedness, and any statement provided under section 8 including creditors' consents. The affidavit shall be filed with the office of the local registrar of the court.[41] 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.[42]

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.

[40] BSA, s.8.
[41] BSA, s.11.
[42] BSA, s.19.

The Court must be satisfied that the sale is advantageous to the seller and will not impair the seller's ability to pay creditors in full.[43]

4.8.3 *Meaning of "Creditor" under the BSA*

A "creditor" is defined under the BSA as "any creditor, including an unsecured trade creditor and a secured trade creditor". An "unsecured trade creditor" is defined as "a person to whom a seller is indebted for stock, money or services furnished or for the purpose of enabling the seller to carry on a business, whether or not the debt is due, and who holds no security or who is entitled to no preference in respect of a claim". A "secured trade creditor" is defined under the BSA as "a person to whom a seller is indebted whether or not the debt is due (a) for stock, money or services furnished for the purpose of enabling the seller to carry on business; or (b) for rental of premises in or from which the seller carries on business, and who holds security or is entitled to a preference in respect of a claim". Given the circular definition of the term "creditor" under the BSA, an analysis of the judicial interpretation of the term is necessary.

In *Pizzolati & Chittaro Manufacturing Co. Ltd. v. May*[44], the Ontario Court of Appeal held that a person with an unliquidated claim for damages does not fall within the scope of the term "creditor" as that term is used in the BSA. The Court emphasized that the wording in the BSA and the requisite forms was not sufficient to change the common law definition of the term "creditor" under which unliquidated claims were clearly not included. The Court in *Pizzolati* also explained that the definition of the term "creditor" under the BSA is dissimilar from that under the BIA, which clearly defined "creditor" as including a person with an unliquidated claim.[45]

4.8.4 A sale in bulk is voidable unless the buyer has complied with the provisions of the BSA. An action or proceeding to set aside or have a sale in bulk declared void may be brought or taken by a "creditor" of the seller within six months after the date in which the documents were filed under section 11 of the BSA. If a sale in bulk has been set aside or declared void and the buyer has received or taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof, including all money, security and property realized or taken by the buyer from, out of, or on account of, the sale or other disposition by the buyer of the stock in bulk (section 16(2)). 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.[46]

It should also be noted that the Ontario Court of Appeal has made it clear in the recent decision *Sidaplex-Plastic Suppliers Inc. v. Elta Group Inc.*[47], that an asset sale which is not in compliance with the BSA is valid until set aside. However, the

[43] BSA, s.3.
[44] [1972] 2 O.R. 606 (C.A.).
[45] See also *Gordon v. Assegai Inc.*, [1989] O.J. No. 556 (H.C.J.)
[46] BSA, s. 16.
[47] (1998), 40 O.R. (3d) 563 (C.A.).

courts have no discretion to refuse to set aside an asset sale which does not comply with the BSA.

Subsection 17(1) of the BSA provides that an action to set aside or have declared void a bulk sale may be brought or taken by a creditor of the seller and, if the seller is bankrupt, by the trustee in bankruptcy of the seller's estate.

4.8.5 *Limitation Periods*

Section 19 of the BSA provides:
No action shall be brought or proceeding taken to set aside or have declared void a sale in bulk for failure to comply with this Act unless the action is brought or the proceeding is taken either before the buyer complies with section 11 or within six months after the buyer complies with section 11.

QUESTION 5

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5. *Enforcement*

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

5.1 *Introduction*

5.1.1 In the event of a company going into bankruptcy, the authority and powers of the directors are superseded following such an appointment and taken over by the trustee. Consequently, in most cases it is the trustee who has the power to bring actions, but there are a few exceptions to this rule by which an action may be brought by creditors or others directly.

5.1.2 The primary exception to this general rule is with respect to criminal proceedings which have been set out in Question 2 above. All criminal proceedings are handled by the Crown prosecutor.

5.2 *Criminal proceedings*

5.2.1 The following acts are criminal offences in which the Crown prosecutor may bring an action against the directors and others involved. The trustee in bankruptcy of a company is under a duty to bring any such offences to the attention of the Superintendent of Bankruptcy who will, in turn, deal with the appropriate authority.

Offences:

(a) fraudulent disposition of a bankrupt's property;

(b) refusal or neglect to answer fully and truthfully all proper questions put to the bankrupt;

(c) falsifying entries or knowingly making material omissions to the statement or accounting;

(d) concealment, destruction, mutilation, falsification, omission or dispositions of property;

(e) obtaining credit by false representations;

(f) fraudulently concealing or removing property of value;

(g) hypothecation, pledging or disposition of property that the bankrupt has obtained on credit and not paid for in the 1 year preceding the date of the initial bankruptcy event.[48]

5.3 Civil proceedings

5.3.1 The trustee in bankruptcy is the party who will bring proceedings such as reviewable transactions, fraudulent preferences, settlements, and fraudulent conveyances.

5.3.2 With respect to the oppression remedy, the situation is somewhat uncertain. A creditor may be entitled to seek relief under the oppression remedy as a "complainant". A "complainant" is defined to include a "registered holder or beneficial owner, and a former registered holder or beneficial owner of a security of a corporation or any of its affiliates", "a director or officer" and "any other person who, in the discretion of a court, is a proper person to make an application". Under both the OBCA and the CBCA, the term "security" includes a "debt obligation" and therefore the beneficial holder of a debt instrument qualifies as a complainant.[49]

5.3.3 The courts have held that a creditor may be a "proper person" for the purposes of the oppression remedy.

5.3.4 There is conflicting case law on the issue of whether or not a trustee in bankruptcy can assert the oppression remedy on behalf of creditors. The argument in favour of allowing the trustee to be a proper person is that the trustee is the representative of the creditors of the bankrupt estate and has all the causes of action of the bankrupt. However, the contrary position states that the trustee in bankruptcy takes the property of the bankrupt as he finds it and that, subject to statutory provisions such as those dealing with fraudulent preferences and settlements, the trustee only obtains the rights of the bankrupt and no more. If a transaction was approved by the directors of the bankrupt, it follows that the bankrupt itself cannot complain that the conduct of the other contracting parties was oppressive. The rationale is that the transaction can be reviewed under the BIA and therefore the trustee has an adequate remedy. In so concluding, it appears that the trustee has some sort of remedy available in which to challenge questionable conduct.

[48] BIA, s. 198(1).
[49] CBCA, s. 241 and 248; and OBCA, s. 248 and 245.

5.4 *Other*

5.4.1 Although it is beyond the scope of this study, directors are also liable to ensure that certain statutory trust deductions from employee wages are remitted to the government taxing authorities. These trusts include income tax, pension plan contributions and employment insurance. Liability also exists for goods and services tax and provincial sales tax and others. Governments have enforcement mechanisms against directors.

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**
BIA General	Where a person has suffered a loss or damage as a result of an offence committed under the BIA, the court may order the person convicted to pay to the victim or to the trustee of the bankrupt estate an amount by way of satisfaction or compensation for the loss of or damage to property.
Reviewable Transaction	In the case when the court finds that the bankrupt entered into a non-arms' length transaction and the consideration was conspicuously greater or less than the fair market value of the goods or services contracted for, than the court may order that the other party to the transaction pay to the trustee the difference between the consideration actually paid and the fair market value.
Fraudulent Preference	When the court holds that a transaction is a fraudulent preference, then the transaction is void as against the trustee. The trustee has the right to recover the property of the bankrupt given to the creditor as consideration for the transaction.
Settlement	When the court holds that the transaction is a settlement, then the transaction is void as against the trustee. The trustee has the right to recover the property or proceeds.
Fraudulent Conveyance	When the court holds that the transaction is a fraudulent conveyance then the transaction is void as against the trustee. The trustee has a right to recover the property that was transferred or the proceeds resulting therefrom.

Declared Dividends	Where a corporation that is bankrupt has paid a dividend at a time when the corporation was insolvent or the payment of the dividend rendered the corporation insolvent, the court may grant judgment to the trustee against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest thereon that has not been paid to the corporation.
Bulk Sales Legislation	A sale in bulk is voidable unless the buyer has complied with the provisions of the BSA. If a sale in bulk has been set aside or declared void and the buyer has taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof.

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 company's affairs***

7.1.1 Where a bankrupt is a corporation, the officer executing the assignment, or such (a) officer of the corporation; or (b) person who has, or has had, directly or indirectly, control of the corporation as the official receiver may specify, shall attend before the official receiver for examination and shall perform all of the duties imposed on a bankrupt by s. 158, and, in case of failure to do so, the officer or person is punishable as though that officer or person were the bankrupt.

7.1.2 Section 158 of the BIA imposes 18 duties on a bankrupt. Section 158(a) obligates the bankrupt to inform the trustee of all property that is under his possession or control and to deliver it to the trustee. Sections 16(3) to 17(2) set out the duties and powers of the trustee in obtaining possession of the property of the bankrupt. Other relevant duties include:

(a) delivery to the trustee of all books, records, documents, writings and papers relating to the property or affairs of the bankrupt;

(b) 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;

(c) preparing and submitting to the trustee a statement of the bankrupt's affairs;

(d) making or giving all the assistance within his power to the trustee and making an inventory of assets;

(e) making disclosure to the trustee of all property disposed of within the period beginning on the day that is 1 year before the date of the initial bankruptcy event or such other date as the court may direct;

(f) making disclosure to the trustee of all property disposed of by gift or settlement without adequate valuable consideration in the 5 year period prior to the bankruptcy;

(g) attending the first meeting of creditors;

(h) when required, attending other meetings of creditors or of the inspectors or attend on the trustee;

(i) to submitting to such other examinations under oath with respect to property as may be required;

(j) to aiding to the utmost of his power, in the realization of the property and the distribution of proceeds among creditors;

(k) executing such powers of attorneys, conveyances, deeds and instruments as may be required;

(l) examining the correctness of all proofs of claim filed, if required by the trustee;

(m) in the case of any person that to his knowledge has filed a false claim, disclosing that fact to the trustee;

(n) doing such acts or things in relation to his property in the distribution of the proceeds among his creditor as may be reasonably required for the trustee.[50]

7.1.3 By section 198(2) of the BIA, it is an offence for the bankrupt, without reasonable cause, to fail to perform the duties imposed by section 158.

7.1.4 Under an examination, a witness may claim the protection of section 5(2) of the *Canada Evidence Act.* This section does not permit the witness to avoid answering any questions on the basis that they may be self incriminating, but it does provide protection against self incrimination since the witness' answers cannot be used in any other criminal proceedings thereafter.

[50] BIA, s. 158.

QUESTION 8

8. Appeals and limitation periods

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

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

8.1 *BIA*

8.1.1 The limitation period for bringing an action against the director for any offence punishable by way of indictment is 5 years from the commission of the offence. If the offence is punishable by way of summary conviction, then the limitation period is 3 years from the commission of the offence.[51]

8.2 *Limitation Period for Civil Actions*

8.2.1 In relation to any liabilities created by the BIA or in relation to breaches of directors' fiduciary duties, the limitation period is generally 6 years from the date on which the cause of action accrued.

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

8.3.1 The courts of appeal are given the power and jurisdiction to hear and determine appeals from the Bankruptcy Court. An appeal will only be available, however, in the following cases:

(i) if the point and issue involves future legal rights;

(ii) if the order or decision is likely to affect other causes of a similar nature in the bankruptcy proceedings;

(iii) if the property involved in the appeal exceeds $10,000 in value;

(iv) from the grant or refusal to grant discharge if the aggregate unpaid claims of the creditors exceed $500;

(v) in any other case, by leave of a judge of the Court of Appeal.[52]

[51] *Can. (A.G.) v. Hamelin* (1986), 62 C.B.R. (N.S.) 96 (Ont. S.C.).
[52] BIA, s. 193.

8.3.2 An appeal from the decision of the Court of Appeal is only available with special leave granted by the Supreme Court of Canada.

8.3.3 The courts of appeal are given the power and jurisdiction to hear and determine appeals from convictions and sentences in criminal matters. Such appeals must be filed within 30 days from the initial decision. An appeal will only be available in an indictable matter:

(a) against a conviction;

(i) on a question of law alone;
(ii) on a question of fact or a question of mixed fact and law with leave of the Court of Appeal; or
(iii) on any other ground with leave of the Court of Appeal; or

(b) against a sentence with leave of the Court of Appeal, unless the sentence is one fixed by law.[53]

An appeal is available in summary conviction matters as of right with no leave requirements.[54]

QUESTION 9

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9. Foreign Corporations

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

9.1 ***Introduction***

9.1.1 The legal provisions and procedures outlined in the BIA apply to individuals and corporations. The BIA defines a corporation as including any "incorporated company, wherever incorporated, that is authorized to carry on business in Canada or that has an office or property in Canada". Banks, authorized foreign banks within the meaning of section 2 of the *Bank Act*, insurance companies, trust companies, loan companies and railway companies are excluded from the BIA.

9.1.2 In general, all the provisions of the BIA relating to the administration of a Canadian company will apply equally to the administration of a foreign company.

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[53] *Criminal Code* R.S.C. 1985 c. C-46, as amended, s. 675(1).
[54] *Criminal Code*, s. 813(a).

9.2 ***Jurisdiction of Canadian Courts***

9.2.1 If no foreign proceeding has been taken against the debtor, all the property of the bankrupt, both moveable and immoveable, vests in the trustee in bankruptcy when bankruptcy occurs. To obtain possession, the trustee may have to comply with the formal requirements of the law of the jurisdiction where the property is located, but legal title is conferred on the trustee by the BIA.

The BIA provides no specific criteria which will allow Canadian Courts to administer a foreign company. The Courts have developed a general test whereby they must find a sufficient connection with the local jurisdiction which may, but does not necessarily have to, consist of assets within the jurisdiction of the Court.

9.2.2 The Court may seek the aid and assistance of a court, tribunal or other authority in a foreign proceeding by order or written request or otherwise as the Court considers appropriate.[55]

9.2.3 A foreign representative is defined in the BIA as meaning a person, other then a debtor, holding office under the law of a jurisdiction outside Canada who, irrespective of the person's designation, is assigned, under the laws of the jurisdiction outside Canada, functions in connection with a foreign proceeding that are similar to those performed by a trustee, liquidator, administrator or receiver appointed by the court. A foreign representative may commence and continue a proceeding for a receiving order, interim receiver and for a proposal in respect of a debtor as if the foreign representative were a creditor, trustee, liquidator or receiver of property of the debtor, or the debtor as the case may be.[56]

9.3

9.3.1 As noted in paragraph 9.1.2 above, the general principle is that following a receiving order being made against a foreign company, all the provisions of the BIA will apply in the same way as for a Canadian company.

QUESTION 10

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10. Insurance

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

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[55] BIA, s. 271(1).
[56] BIA, s. 267 and 270

10.1 ***Directors' liability insurance is available in Canada.***

Generally, the coverage that is available to the directors will cover amounts that the directors are legally required to pay as a result of any claim brought against them as a result of wrongful acts, and includes damages, judgments, settlements and defence costs, but excludes fines, penalties, punitive and exemplary damages and any other charges deemed uninsurable. Generally, the coverage will also provide for reimbursement of the costs of a successful defence of penal charges brought in Canada against the directors.

In order to obtain this type of insurance, the directors and its officers must certify that specific standards are met in the operations regarding environmental issues and that the company does not, at the time of requesting the policy, have any exposure to the directors of the organization.

In addition, it is easier to obtain directors insurance for directors of the board who are not involved in the day to day operations of the business than for directors involved in the day to day operations of the business and in the decision making.

10.2 ***The standard exclusions in the directors' and officers' liability insurance can be grouped into three broad categories:***

1. 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.

2. 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.

3. Those which are specific to the nature and purpose of directors' and officers' policies, such as:

   · Pending or prior litigation;

- Circumstances known at the time the policy came into effect;
- Claims made by an organization or on its behalf;
- Claims made by directors or officers, except wrongful dismissal by former officers;
- Wrongful acts committed before the company became a subsidiary of the organization; and
- Service on the Board of Directors of companies other than the insured company or its subsidiaries.

10.3 ***Prior to obtaining any directors' and officers' insurance coverage the insurance company will require that:***

A. The organization treasurer certifies that the following specific issues have been dealt with and are being dealt with within the corporation:

- that the company is not in arrears in the payment of wages, benefits, valuation or any form of compensation;
- that there are no outstanding claims made by any employee or former employee of the organization for unpaid compensation;
- the organization is not in arrears in either withholding or remitting to the government agency any amount required to withhold and remit under the following statutes:
- Income Tax Act;
- Provincial Taxation Act (which is applicable to a specific location of the company);
- Canada Pension Plan (Canada);
- Unemployment Insurance Act (Canada);
- Ontario Health Insurance Plan;
- Act respecting Occupational Health and Safety;
- Excise Tax Act (Canada) including Goods & Services Tax;
- Pension Benefits Act, 1987; and
- any other statute, regulation, order, judgment, decree or official directive of a government body, whether or not having a force of law, under which failure to withhold and remit such sums would give rise to a claim against the directors of the organization.

B. The Board of Directors and Officers involved with Environmental compliance must certify that the issues discussed below have been dealt with or are not occurring in order to obtain insurance.

- The general thrust of the certificate is that the Board of Directors must certify that the employees are trained to handle waste and hazardous material and that they complied with the environmental laws.

- That there have not been spills, releases, deposits, emissions or discharge of any contaminated materials, waste or hazardous materials except for (must advise of any issues); and that any such spills have been reported and remedied in substantial compliance with all applicable environmental laws.

- The organization has obtained all necessary and required permits, licenses, and certificates of approval required for its operations under any applicable environmental laws.

- All waste generated by operations or the organization has been delivered to licensed waste removers and disposed with licensed waste disposal firms as required with the environmental laws.

- The organization has not been subjected to any order, direction, notice of defaults, warrants or any pending order in relation to a violation or alleged violation of any applicable environmental law.

QUESTION 11

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

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

Firstly, with respect to the duty of care, directors must act in an informed and considered manner. Directors should review all material information available to them and, with this information in mind, act with "requisite care". In Canada, this duty is codified in corporate statutes requiring directors to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

In the event of insolvency, even outside of a formal bankruptcy, directors of an insolvent corporation continue to owe their duties to the corporation, but those duties must be exercised in a manner that does not disregard or prejudice the interest of creditors.

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.

11.1.2 ***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.

11.1.3 Directors should act in accordance with the business judgment rule. They should avoid actual conflicts of interest, avoid preferential treatment of certain constituencies, disclose all potential director contacts or relationships that could create even an appearance of a conflict of interest, and they should act only with the requisite information and due deliberation.

In addition, directors should ensure that their actions meet the "fairness test". The demonstrable "fairness" of an action will provide protection if the business judgment rule is not applicable.

Directors should obtain advice of outside professionals for any significant board action, including advice regarding the application of fiduciary duties and alternatives to the proposed course of action.

Finally, directors should ensure that there is adequate support for their decisions, such as reports of officers or outside advisers, which should be obtained and then reviewed by the board and reflected in the records of the board's deliberations.

11.1.4 It should be noted that in a recent 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.[57] 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.

[57] *NBD Bank, Canada v. Dofasco Inc.*(2000), 46 O.R. (3d) 514 (C.A.).

APPENDIX

Summary of Canadian bankruptcy and insolvency law

Introduction

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. However, until recent years, Canadian insolvency law did not provide legislative framework. As a result of amendments in 1992 and 1997, Canadian reorganizations can now be effected under two regimes: the *Companies' Creditors Arrangement Act* ("CCAA") and the *Bankruptcy and Insolvency Act* (the "BIA").

Debt Recovery

Before embarking upon a discussion of reorganizations and insolvency laws in Canada, we must first consider issues pertaining to the recovery of debts and the enforcement of security by lenders.

Types of Financing

The two basic types of financing are secured and unsecured. Unsecured financings are generally governed by the contractual terms on which the loans were made. The law of contract is a matter of provincial law under the Canadian constitution. As is the case in most common law jurisdictions, except in very specific situations (eg. mareva injunctions), there is no execution before judgment. What this means is that an unsecured creditor who is owed money and not paid must commence legal proceedings and obtain judgment. It is only after judgment is obtained that the assets of the debtor may be seized and sold to satisfy the debt. This can be a very slow and costly process.

Security may be taken against either personal property or real property. The interpretation of security agreements and their enforcement are, in general, matters of provincial law in Canada. The primary exception is "Bank Act security" under section 427 of the Canadian *Bank Act*, which is available only to banking institutions (as opposed to other lending institutions), and which is, essentially, only available to secure an interest in the debtor's inventory and receivables.

Real estate security is governed by provincial mortgage lending statutes, which regulate both the way in which such security is taken and the way in which it is enforced. In most common law provinces including Ontario (Quebec is a civil law jurisdiction), security against personal property is governed by the particular province's *Personal Property Security Act* ("PPSA"). The PPSA is legislation modeled substantially on Article 9 of the Uniform Commercial Code. As with Article 9 of the UCC, PPSA legislation governs the taking, perfection, priority and enforcement of security in the particular province.

Enforcement of Security

The 1992 amendments to the BIA had a significant impact on the enforcement of security in Canada. Prior to 1992, a secured creditor wishing to enforce its security was required to notify the debtor of the default, demand payment of the debt and give the debtor a "reasonable period of time" to repay before taking any action to enforce its security. Determining what is a reasonable period of time is an imprecise factual issue. However, the debtor could waive that notice at any time and, in certain circumstances, demand and enforcement could be simultaneous.

Section 244 of the BIA now provides that a secured creditor which intends to enforce its security on all or substantially all of the inventory, accounts receivable or other property of an insolvent person used in relation to its business, must send the insolvent person a notice of its intention in a prescribed form and manner. The secured creditor is then prohibited from enforcing its security for 10 days after sending the notice, unless the insolvent person consents to earlier enforcement. However, 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. As a further note, this 10 day period runs concurrent with and is considered part of the reasonable period of time.

Once section 244 of the BIA has been complied with, if necessary, there are a number of ways for secured creditors to enforce their security.

Self-Help

In PPSA jurisdictions, upon default under a security agreement (including all forms of secured financings), a secured creditor is entitled to exercise self-help remedies and take possession of the collateral. Where appropriate, possession may also be taken by rendering the collateral unusable. A secured creditor who has taken possession generally has the right, upon certain notice provisions being complied with to either sell the collateral (by private or public sale, so long as it is commercially reasonable) to recover the indebtedness or to foreclose and take the collateral in satisfaction of the debt. However, should the debtor or others with an interest in the collateral object to a foreclosure, the secured creditor will be required to sell the collateral. Exercising foreclosure extinguishes the debt and prevents recovery of any deficiency, whereas the sale process does not.

Appointment of Receiver

Where provided for in the security agreement, a secured creditor may have the right to appoint a private receiver or receiver and manager to take possession of and realize upon the collateral on behalf of the secured creditor. This is often done where the secured creditor desires the assistance of an accounting firm to act as its agent to commence the realization process.

A secured creditor also has the right to seek the appointment of a court-appointed receiver or receiver and manager to assist in the enforcement or realization process. This remedy is usually used where difficulty is expected in exercising self-help remedies

or appointing a private receiver, or where the secured party wishes to obtain the protection of a court appointment. As a result of the court's involvement, this process is generally slower and more costly, but does allow the secured creditor to have its enforcement and realization process approved by the court so as to minimize the risk of criticism or lender liability issues.

Liquidation

The liquidation of most businesses in Canada is conducted under the BIA. Upon the bankruptcy of a debtor, whether voluntarily or upon the petition of a creditor, the BIA imposes a stay of proceedings in respect of the debtor. In the liquidation context, the stay of proceedings does not generally apply to secured creditors (the scope of the stay of proceedings in a Proposal under the BIA is discussed below), who are free to exercise their rights of self-help or to otherwise realize on their security outside of the BIA. There is one exception to this rule, which has been guarded jealously by Canadian Bankruptcy Courts. Upon the application of the debtor, the Bankruptcy Court may, in exceptional cases, stay the rights of a secured creditor for up to six months. For the most part, however, upon bankruptcy, secured creditors may proceed to realize upon their collateral with impunity.

Reorganizations

As with Chapter 11 of the U.S. Code, the purpose of Canadian reorganization laws is to allow a financially troubled business to remain in possession of its assets and restructure its affairs under the court's supervision so as to avoid liquidation and the consequent loss of jobs and goodwill. The two primary statutory options for reorganizing a financially troubled business in Canada are the CCAA and Proposals under the BIA.

CCAA

Generally

The CCAA is a federal statute which was enacted in the 1930's, but which has recently become a favourite refuge of Canadian companies in financial difficulty. Its recent popularity is largely due to the fact that, unlike the pre-1992 Canadian *Bankruptcy Act*, the CCAA can be used to stay non-creditors, secured creditors and unsecured creditors while restructuring the company's secured and unsecured debt. The practical aspects of a CCAA proceeding are, after its commencement, similar to Chapter 11 proceedings. In fact, the CCAA might be thought of as Chapter 11 without legislative rules.

Procedure

CCAA proceedings are commenced by the issuance of a court order upon an application brought by either the debtor or its creditors. Most often the debtor brings the application itself. Generally, the application seeks:

- a declaration from the court that the debtor is a corporation to which the CCAA applies;

- an order that the debtor file a plan of arrangement within a certain time frame and hold meetings of classes of creditors; and

- an interim stay of all actions, suits and other proceedings against the debtor.

A debtor will be a corporation to which the CCAA applies if:

- it is a Canadian company, has assets in Canada or carries on business in Canada;

- it is insolvent or has committed an act of bankruptcy (a defined term in the BIA); and

- it has outstanding indebtedness in excess of $5 million.

Stay of Proceedings

The most attractive feature of CCAA protection, from a debtor's perspective, is probably the discretion given to the court in granting a stay of proceedings. The CCAA permits the court to order a stay of proceedings which is effectively as broad as, or arguably broader than, the stay imposed under section 362 of the U.S. Code. Generally, a CCAA stay 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

Prior to September 30, 1997, a court would grant a stay of proceedings under the CCAA for as long as it deemed appropriate. However, 1997 amendments to the CCAA now provide that the initial stay of proceedings 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 now 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. Prior to 1997, this had been a standard practice, but the 1997 amendments codified it. 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.

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 undersecured 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 51% in number and two-thirds in value of the claims of that class present and voting in person or by proxy.

Court Sanction

If the statutory majority of any class approves the plan and the plan is sanctioned by the court, every creditor in that class will be bound by the plan. Once approved by the requisite majority of creditors, the plan must be sanctioned by the court before it can be effective. The court will only sanction the plan if it is satisfied that the plan is fair and reasonable. Once this has been done, the plan is binding on all classes of creditors who have accepted the plan, as if it were a contract between the debtor and those creditors.

The primary advantages of the CCAA include the ability to obtain a broadly worded stay order and the flexibility accorded the debtor by the lack of a comprehensive legislative framework.

There are, however, disadvantages to this procedure. First, there is no certainty that relief will be granted; relief is completely in the discretion of the court and there are precedents for the rejection of applications on a number of grounds, both technical and substantive. In addition, due to the high level of court supervision and the lack of a specific statutory framework, the costs incurred in a CCAA reorganization can be

prohibitive. As well, unlike Chapter 11's DIP financing, the debtor is not statutorily entitled to receive financing during the reorganization and may only do so with the consent of the court and in most cases with the consent of secured creditors affected by such financing.

Proposals Under The BIA

Since 1949, Canadian bankruptcy legislation has contained proposal provisions to enable troubled companies to reorganize their affairs. However, prior to 1992, those proposal provisions were only binding upon unsecured creditors. Therefore, unless the debtor was able to obtain the cooperation of its secured creditors, it could not effectively reorganize its affairs under that legislation. However, by its application to secured creditors, Part III of the BIA has established an effective legislative framework for reorganization in Canada in which judicial participation is encouraged to balance the rights of creditors in general and the debtor's opportunity to reorganize.

Commercial Reorganizations

Commercial reorganizations under the BIA are conducted by way of "Proposals", which may be made by an "insolvent person", a receiver, a liquidator, a bankrupt or the trustee of the bankrupt's estate. By definition, an "insolvent person" includes all forms of business entities and, therefore, the BIA's proposal provisions are not restricted to corporate entities. Unlike Chapter 11 reorganizations, a proposal under the BIA must name a licensed trustee in bankruptcy to act as trustee under the proposal. The trustee under a proposal has a number of legislatively mandated duties and responsibilities in respect of the debtor and the proposal itself, including assisting with the preparation of financial information regarding the debtor and reporting to both the court and creditors. A proposal is initiated when it is filed with the Official Receiver, the federal government appointee responsible for administering the BIA.

Proposals under the BIA may be made to creditors generally or to classes of creditors, both secured and unsecured. Whereas proposals under the previous legislation generally did not include provisions for secured creditors, 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. A creditor cannot initiate 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 document called a notice of intention to file a proposal. A notice of intention is a simple one page statement signed by the debtor and filed with the Official Receiver, and which must include the consent of a trustee in bankruptcy who has agreed to act as trustee under the proposal and a list of all creditors with claims exceeding $250. It is

interesting to note that only an “insolvent person” may initiate a reorganization by filing a notice of intention; a bankrupt, trustee, receiver or liquidator is not entitled to do so. Thus, it is clear that the notice of intention provisions are intended to create a procedure for the reorganization of troubled businesses which are not yet subject to bankruptcy or receivership proceedings.

The trustee named in the proposal or the notice of intention is required to notify all known creditors of the filing and, in the case of a proposal, the date of the meeting of creditors to consider the proposal. As well, the debtor must file, and the trustee must verify, cash flow statements in connection with the commencement of a reorganization under the BIA.

In a Chapter 11 reorganization, subject to the discretion of the courts, the debtor has 120 days within which it is the only party which may file a plan and a further 60 days to seek acceptance of that plan by creditors before other parties can propose plans. Often, six months time is given, as a minimum, to reorganize under Chapter 11. Under the BIA, this is intended to be the maximum time period.

Under the BIA, after filing a notice of intention, the debtor has 30 days to file a proposal with the Official Receiver. However, this 30 day period may be extended, on application to the court, for up to a maximum of 5 additional months, provided that such extensions are solely for the purpose of enabling the debtor to file its proposal and that they may only be granted for periods of up to 45 days at a time. After the proposal has been filed with the Official Receiver, the trustee is required to hold a meeting of creditors within 21 days. The trustee must notify the creditors at least 10 days before the meeting. Therefore, by filing a notice of intention and a proposal under the BIA, and subject to the court’s discretion in granting extensions, a debtor may provide itself with a 6 _ month period within which to formulate and obtain approval for a proposal.

Stay of Proceedings

Perhaps the most important provision of the BIA relating to proposals is the stay of proceedings. As with section 362 of the U.S. Bankruptcy Code, the stay of proceedings arises automatically upon the filing of a notice of intention or a proposal and operates to bind all creditors, secured and unsecured, as well as the federal and provincial governments in respect of their rights of garnishment, etc., for various claims. The stay operates throughout the period from the date of filing of the notice of intention or proposal to the date of court approval and, in respect of those debts caught by the proposal, beyond. In Canadian bankruptcy law, this is a fairly radical concept, since secured creditors are now automatically precluded by statute from relying on clauses in their security agreements which purport to terminate the debtor’s ability to deal with the collateral upon insolvency.

There are, however, certain exceptions to the application of this stay. With respect to secured creditors, those who actually took possession of secured assets before the debtor filed its notice of intention or proposal are excluded, as are those who actually gave a notice of intention to enforce their security more than 10 days prior to the debtor’s notice of intention or proposal. As well, the stay does not apply to secured creditors who are not included within the debtor’s proposal, or who are in a class of secured creditors which has rejected the proposal. In addition, secured creditors have

the statutory right to apply to the court to lift the stay of proceedings where they can show that their security position is deteriorating or detrimentally affected by the stay imposed under the proposal.

The stay provisions of the BIA prohibit the termination of contracts entered into between third parties and the debtor. Upon the filing of a notice of intention or proposal, any party to an agreement with the debtor is prohibited from terminating, amending or claiming an accelerated payment under the agreement as a result of the debtor's insolvency, or its filing of a notice of intention or a proposal. With respect to leases, lessors and licensors are precluded from terminating their agreements by reason of pre-filing defaults or arrears in payments. As well, the BIA provides that these prohibitions cannot be waived or varied in advance by contract. However, persons affected by these provisions are entitled to require post-filing payments to be made in cash, and are not required to make further advances of money or credit.

Disclaimer of Commercial Leases

Under previous bankruptcy legislation in Canada, trustees in bankruptcy were able to disclaim leases and thereby terminate lease obligations. However, unlike their U.S. counterparts, prior to 1992 debtors were not able to terminate lease obligations in proposals.

Under the BIA, a debtor who has filed a notice of intention and has determined, in the course of preparing its proposal, that it must reduce its lease obligations, is given the option of disclaiming any one or more of its commercial leases on 30 days written notice to the respective landlords. It is important to note, however, that such a notice may only be delivered between the filing of a notice of intention to make a proposal and the filing of the proposal, or on the filing of a proposal.

In connection with such a disclaimer, the landlord has no claim for accelerated rent (as it might in a bankruptcy) and becomes entitled to file a proof of claim in the proposal. The proposal itself must state whether the landlords with disclaimed leases are to be placed in their own class as creditors or with other unsecured creditors. As well, the proposal must indicate whether the landlords may file a proof of claim for their actual losses as a result of the disclaimer, or for an amount equal to the lesser of (i) the aggregate of the rent under the lease for the next year plus 15% of the rent for the remainder of the term of the lease after that year, and (ii) three years rent under the lease.

Of course, the proposal will also detail the compromise which the debtor proposes for such claims.

A landlord may object to a proposed disclaimer by applying to the court for a declaration that the disclaimer does not apply to a particular lease. On such an application, the court must make the declaration unless the debtor satisfies the court that it will be unable to make a viable proposal to its creditors without being able to disclaim all of the leases in question.

Classes of Creditors

In general, all unsecured creditors will be placed in one class. However, there may be circumstances in which there will be more than one class of unsecured creditors. As with the CCAA, secured creditors will generally be included in the same class if their interests are sufficiently similar to give them a "commonality of interest". The BIA does provide 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 deliberately exclude a secured creditor or group of secured creditors from its proposal. Therefore, a debtor is able to determine which secured creditors it wishes to impose a stay of proceedings against.

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 50% 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 government's bankruptcy branch. 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. Particular types of claims must be paid promptly as a condition of obtaining court approval, including certain claims of the Crown and all arrears of employee wages, vacation pay and expenses.

It is clear that the Canadian government has taken great strides towards creating an effective and comprehensive reorganization framework under the BIA. There will be a number of advantages to this legislation, not all of which are yet known since these provisions are, for the most part, relatively new. However, 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 liquidation, 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. Upon the appointment of a receiver over all or substantially all of the assets of the debtor, or upon the debtor's bankruptcy, suppliers of that debtor may have access to and repossess their goods if they present a written demand for repossession to the debtor, the trustee or the 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.

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 in 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

In recent years, 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 now provides that receivers and trustees in bankruptcy are not personally liable for any environmental damage which occurred either before or after the date of their appointment, unless the damage resulted from the failure of the receiver or the trustee, as the case may be, to exercise due diligence. Receivers and trustees in bankruptcy, however, must still comply with any reporting requirements imposed by environmental legislation at the federal or provincial level.

CHINA

Introduction

It is absolutely necessary to have an introductory note before dealing with the questionnaire, since the business and legal environment in China is significantly different from almost all other jurisdictions in the world. Under the so-called socialist market economy, the government has still maintained its control not only over the market development as a policy maker and market regulator, but also over many companies and enterprises as a stake owner. Such conflicting roles of the government have led to defective legislation, lax enforcement and various problems of corporate governance.

Presently, China does not have a uniform business enterprise law. The current framework sees dual-track legislation: on the one line there are enterprise laws that are adopted based on ownership classification, such as State-Owned Enterprises Law (1986), Urban Collective Enterprise Law (1991), Sino-Foreign Equity Joint Venture Law (1979 as amended in 2001), Sino-Foreign Contractual Joint Venture Law (1988 as amended in 2000), and Wholly Foreign Owned Enterprise Law (1986 as amended in 2000). On the other line, Company Law (1993 as amended in 1999), Partnership Enterprise Law (1997) and Sole Proprietorship Enterprise Law (1999) are also introduced into China. As a result, it seems impossible to find consistent rules governing directors' liabilities and to discuss them one by one within this project. Thus, this report will have its primary focus on the provisions of the Company Law and related regulations.

Moreover, the underdevelopment of the legal infrastructure in China has also hindered the modernization of the rules governing directors' liabilities. China enacted its first Enterprise Bankruptcy Law in 1986. But the Law may only be applicable to state-owned enterprises ("SOEs") and a considerable part has proved outdated today. In the Company Law, merely less than 10 articles are set out to deal with company bankruptcy, dissolution and liquidation. Although China has endeavoured to modernize its bankruptcy regime since 1994, the controversies on the technical issues, together with ideological difficulties still subject the enactment to uncertainty.[1] Consequently, both the enterprises and the judiciary have to heavily rely on the government policy and circular as the practical guidance. Further, as a socialist country with a strong civil law tradition, judicial decisions are neither systematically reported, nor followed as precedent. However, some cases are selectively reported in order to remedy the defective regime. As such, these judicial decisions may serve as indicators of development trend.

Against this backdrop, this report is made on the basis of the current law, government decrees, judicial interpretation of the Supreme People's Court, and certain ministry regulations. Despite the defective conditions, it is the authors' hope to reflect the current state of the legal framework in this regard and make a contribution to this world-wide comparative study.

[1] In 1995 a comprehensive draft of the uniform Bankruptcy Law was completed. However, the unripe social and legal conditions caused the draft to be shelved for a long time. The drafting process only resumed in 1998 and is now continuing. Although December 2000 saw the completion of a new draft by the drafting group, the enactment has not been penciled down on the agenda of the national legislature. As such, it is not clear to what extent the draft will be further revised and when it may be adopted.

QUESTION 1

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

Generally Article 35 of SOE Bankruptcy Law allows the avoidance power to be exercised to attack transactions of unfair preference within six months before the period from the acceptance of the bankruptcy case by the People's Court to its issue of the bankruptcy declaration. These transactions include concealment or partition of assets of the debtor enterprise, transfer of assets without consideration, sales of assets below reasonable value, provision of security to unsecured debts, payment of pre-mature debts and giving up of the claims that the enterprise may exercise. Article 40 provides that the People's Court shall recover the assets concerned if the unfair preference is discovered within one year of the conclusion of the bankruptcy proceedings. Article 41 further stipulates administrative and even criminal liabilities against the responsible persons for the conducts listed above. These rules may also be applicable to other enterprises by the reference of the Civil Procedure Law of China by the People's Court.[2]

However, given the infancy of the bankruptcy regime, the current rules seem to offer little definition of the "twilight period". The defective corporate as well as the bankruptcy regime has created loopholes for insolvency fraud against state assets where the state-owned companies or enterprises are left as empty shells after the assets are transferred or pocketed by directors. To combat the fraudulent bankruptcy practice, the State Council in a decree dated March 2, 1997 adopted certain measures, including disqualification of senior officers of a bankrupt SOE and imposition of administrative and even criminal liabilities. It is stated that the legal liability must be affixed once the fraudulent bankruptcy is found.[3] On March 6, 1997 the Supreme People Court echoed the Central Government position by issuing a circular to the lower courts.[4] It provides particularly in Section 6 that any concealment, partition or transfer of assets of the SOE concerned, either for no consideration or below value, payment of pre-mature debts or giving up of creditor's rights shall be void and the assets concerned shall be recovered if the purpose of the conduct is to escape the debt obligation. These new rules, nonetheless, specify no limitation on the time frame. As a result, the avoidance power in these contexts seems to be exercised beyond the six-month period to attack fraudulent transactions. Hence, the start and end of the "twilight zone" are hardly defined and subject to the government policy guidance and judicial discretion.

[2] Due to the lack of applicable rules, the Supreme People's Court in a judicial interpretation held that People's Court may make reference to the provisions of the SOE Bankruptcy Law in hearing bankruptcy cases of other types of enterprises. The Opinions of the Supreme People's Court on Issues Concerning Application of Civil Procedure Law of July 14, 1992.

[3] Section 7 of the Supplementary Notice of the State Council on Issues Concerning Mergers and Bankruptcy of State Owned Enterprises in Certain Cities on a Trial Basis and Re-employment of Their Workers of March 2, 1997.

[4] Notice of the Supreme People's Court on Issues of Recent Concerns Concerning Trials of Enterprise Bankruptcy Cases of March 6, 1997.

The bankruptcy of Haerbin Purchasing Supply Centre in 1995 may serve a good example in this regard. In this case the Supreme People's Court found that the Centre had withdrawn most of its capital before applied for bankruptcy of a wholesale market it established. Although the withdrawal took place beyond the reach of the avoidance power of six months, the Court allowed the recovery from the Centre according to Article 58 (1) of the General Principles of Civil Law, which states that a contract shall be void if it is used as a means for unlawful activity.[5]

To sum up, the current legal regime does not clearly define the "twilight zone" because the recent government and judicial circular apparently break through the provision of the SOE Bankruptcy Law. It should be further noted that directors of different types of enterprises may be subject to different liabilities in China where the state assets enjoy most legal protections. Also, the nature of a particular transaction is relevant to determine the liability period. Once the state assets and fraudulent purpose are involved, the "twilight zone" may be longer than the normal unfair preference period of six months.

QUESTION 2

2. Actions potentially giving rise to liability for directors

As afore-discussed, the directors' liabilities vary in enterprises of different ownership. The current Company Law with five short articles articulating directors' duties and obligations is considered defective, not only for its over-simplicity,[6] but also for its failure to use the crucial word of "fiduciary" to describe the directors' duties.[7] Under the Company Law, directors and senior officers shall be liable for the damages to the company only if such damages are caused by their violation of the law, regulations or the company's article.[8] As such, the Law fails to provide sufficient, to say the least, legal ground to institute actions of wrongful negligence, abuse of majority's power and transactions under value. Chapter 10 of the Law entitled Legal Liabilities only imposes administrative and criminal liabilities against directors' misappropriate the company's assets[9] and engagement in conflicting business.[10] Article 57 of the Law further disqualifies directors for three years for their personal responsibility for bankruptcy of the company they have served.

[5] 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).
[6] Please see Articles 59-64 of the Company Law that are applicable to both limited liability companies and joint stock companies with limited liability.
[7] Article 59 requires a director to follow the articles of the company, faithfully discharge his duties, to uphold the company's interests and not to seek any personal interest by taking advantage of his power and position in the company. However, some experienced lawyers believe the failure to impose fiduciary duty on directors is a sad mistake. See Nicholas C. Howson," China's Company Law: One Step Forward, Two Steps Back? A Modest Complaint", *Columbia Journal of Asian Law,* No. 1 (1997), at 142-144.
[8] Articles 63 and 118 of the Company Law.
[9] *Ibid.,* Article 214.
[10] *Ibid.,* Article 215.

The Criminal Law of 1997 has some articles against directors for their unlawful profiteering by taking advantages of their positions,[11] for making significant losses to the company by engaging in dealing with family members and friends,[12] for their negligence resulting in a significant loss to the company,[13] and for seeking their own benefit at the cost of the company.[14] However, all these criminal penalties may only be applicable to cases involving state-owned companies and entities. Consequently, the legal means with their effect of determent are not available to private companies and firms against directors' wrong doing. Articles 271 and 272 of the Law also provide causes of actions against directors of all kinds of companies, but only limited to misappropriation.

These rules clearly demonstrate that director of SOEs may face more administrative and criminal penalties than civil liabilities in bankruptcy proceedings. However, the lack of supervision and enforcement has rendered the law not as harsh as it sounds in practice. In companies and other enterprises actions against directors' dishonest trading and transactions would be more difficult simply because there is no detailed provisions on directors' fiduciary duty, nor any rule defining and governing insolvent trading, false representation to company creditors and fraud in anticipation of dissolution.

On the other hand, the unsophisticated legal regime does not allow defences either that are commonly available in other jurisdictions. For example, the imposition of liabilities seems to only focus on the losses or damages to the company without paying sufficient attention to the knowledge or mental state of the director concerned. Worse yet, the underdevelopment of professional services, such as accounting and auditing may make a director more vulnerable in arguing his case for his business Judgment.

QUESTION 3

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

Given the corporate structure and business environment, some other persons may also be liable due to their involvement with the company's affairs during the "twilight zone". First, China's Company Law is based on German model with a supervisory board parallel with the board of directors as an organ to monitoring directors' performance. As a result, a supervisor is treated virtually the same as a director in terms of legal liabilities. By the same token, the managers are also included into the same framework.[15] As such, if supervisors and managers fail to carry out their legal duties, the same liabilities will be imposed.

[11] Article 165 of the Criminal Law.
[12] *Ibid.,* Article 166.
[13] *Ibid.,* Article 167.
[14] *Ibid.,* Articles 168 and 169.
[15] In all the articles of the Company Law examined above, directors, supervisors and managers are named together. In China, excessive concentration of power has been a serious problem of

As a socialist market economy, the government involvement in the operation of many companies and SOEs are still substantial. Consequently, certain state officials may become liable for their wrong doing with the enterprise concerned. Article 42 of the SOE Bankruptcy stipulates that if the upper-level government department is found mainly responsible for the bankruptcy of the enterprise, the leaders of the department shall be disciplined. Where their negligence causes significant losses to the state, they may even be subject to criminal penalties.

Also in many cases bankrupt companies were established by the local government directly without sufficient capital to meet the minimum capital requirement of the law. Although the doctrine of "lifting the corporate veil" is not provided in the Chinese law today, the People's Court in fact has repeatedly applied the rule in practice through judicial interpretation. For example, in Pin Ding Branch of Shaxi Oil Co. v The Oil Development Group of Bai City of Jilin, the Supreme People's Court held that the defendant company's veil should be pierced and the government office was liable to the extent of the registered capital on the finding that the company, without any of its own capital, was established by the local government and the company's assets were later transferred to another firm formed by the same government office before a Judgment was issued in favor of the creditor plaintiff.[16]

As aforementioned, the promoters and shareholders of a company shall be liable for withdrawal of their capital contribution after the formation of the company. Under Article 209 of the Company Law, a fine up to ten per cent of the fund withdrawn shall be imposed. In a serious case, criminal penalties may even be used.

Professionals who are involved in the company's affairs may be liable for their fraudulent conducts in practice, including the "twilight period". Article 219 of the Company stipulates that asset appraising and certifying firms may be fined, closed down and even subject to criminal liabilities for their issuing false documents. In case of negligent omission in appraising and certifying reports, fine, suspension of business and disqualification may be imposed.

The Commercial Bank Law prohibits a commercial bank from granting credit loans to its affiliate or granting other types of loans with preferential conditions.[17] Further, the People's Bank of China as the central bank adopted the General Principles of Loan Granting in 1996. Chapter 11 in particular specifies administrative, civil and criminal liabilities against violations of the banking law and loaning procedures. In addition to subjecting the borrower to criminal penalties who intentionally embezzles the proceeds in way of bankruptcy, the responsible bank staff and any individual or entity that coerces the bank to issue the loan will be disciplined.

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corporate governance where in a large number of companies, the chairmen of the board are also the general managers.

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

[17] Article 40 of the Commercial Bank Law of 1995.

Indeed, the current law does not have many rules on the liability of a third party, except those discussed above. However, the very general and broad provision of the General Principles of Civil Law may always be relied on by the court in handling a third party dealing with a company with knowledge of its insolvency or in conspiracy with the company or its directors. For instance, Article 106 provides that a natural or legal person shall bear civil liabilities for his violation of other's property rights at fault.

QUESTION 4

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

Generally, as discussed above transactions with the company within six months prior to the commencement of the bankruptcy may be vulnerable to the attack of avoidance power, and once a company is liquidated, it may not engage in any new operational activities.[18] However, what constitute "new operational activities" are not defined in the law.

Also under Article 24 of the SOE Bankruptcy Law, the liquidation group may conduct necessary civil activities in accordance with the law, including making decisions on whether to continue to perform contracts of the enterprise.[19] Thus, the counter-parties may still be able to deal with the company in the "twilight zone". However, the current regime includes no specific provision in this regard.

Moreover, the SOE Bankruptcy Law allows an insolvent SOE to carry out reconsolidation within two years if its upper-level authority and the creditors' meeting so agree. In the period of reconsolidation, the enterprise may continue its business operation subject to the supervision of the People's Court and the creditors' meeting as well as the state authority. However, the rescue process shall be terminated if the financial condition of the enterprise continues to deteriorate or the debtor commits unfair preference damaging the interest of creditors.[20] Based on these provisions, it seems likely that some counter-parties may continue to deal with the debtor enterprise subject to the permission of the liquidation committee, creditors' meeting and the relevant state authority. In this regard, the only defence for the counter-parties for validating a transaction with the debtor enterprise would be that such continued dealing benefits the enterprise concerned.

[18] Article 195 of Company Law.
[19] Article 55 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Enterprise Bankruptcy Law of November 7, 1991.
[20] See Chapter 4 of SOE Bankruptcy Law. Also, Chapter 5 of the Supreme People's Court's Opinions, *Ibid.*

QUESTION 5

5. Enforcement actions

According to Article 35 of the SOE Bankruptcy Law, the liquidation committee may petition to the People's Court to avoid the transaction of unfair preference. The upper-level state department of the SOE concerned and the Ministry of Supervision is empowered to discipline the directors responsible for the unfair preference transactions or for losses of the SOE due to their negligence under Articles 41 and 42 of the Law. If the case proves to be very serious, they may further refer the case to the People's Procuratorate for criminal investigation. These organs may also handle the fraudulent bankruptcy cases according to the measures adopted by the State Council and the Supreme People's Court as discussed above.

For all the criminal liabilities as provided in the Company Law and the Criminal Law, it is no doubt that the People's Procuratorate shall bring the action against directors for their offences. However, in practice before the case reaches to that stage, many other state authorities may already get involved in deciding the nature of the case. For instance, the Disciplinary Committee of the Communist Party,[21] the State Asset Management Administration, the Ministry of Supervision, the State Auditing Administration, the State Administration of Industry and Commerce as the business registration authority and the relevant state department in charge of the SOE or company concerned may all participate in the investigation and put forward their opinions.

The company may have a cause of action against directors for breach of their legal duties and for violations of the law and regulations resulting in losses to the Company. The directors concerned shall compensate the company for the losses caused by their wrong-doing and further be accounted for the unlawful income they made by means of corruption, misappropriation, and conflict of interest dealing.[22]

Based on the relationship between the directors and shareholders, the latter should be able to institute legal actions against directors' wrong doing. However, the Company Law includes no specific provision to enable shareholders' derivative action. Indeed, certain ministerial regulations entitle both the company and its shareholders to file legal actions against the directors for their violation of the articles of the company.[23] However, these rules have very limited applicability, such as only to overseas listed companies. Moreover, currently most of companies' articles are very simple and general, which may further hinder shareholders' actions. Further, lack of necessary substantive and procedural rules

[21] Article 17 of Company Law allows activities of the Communist Party in a company.
[22] *Ibid.,* Articles 59 – 63, 118 and 123.
[23] For instance, Article 7 of the Requested Clauses for Articles of Association of Overseas Listed Companies jointly promulgated by the State Securities Commission and the State Economic Reform Commission on August 27, 1994 provides that the company or its shareholders may sue the directors based on the provisions of the articles association.

in this regard has troubled the People's Court in handling such cases. For example, in a widely reported case, a derivative action filed by a foreign shareholder against the chairman of the company could not be entertained by the People's Court.[24]

There is no specific rule for a third party, such as a creditor, to sue directors for any wrong doing during the "twilight zone", the General Principles of Civil Law, such as Article 106 mentioned above, may always come to play a helpful role.

QUESTION 6

6. Remedies: orders available to the domestic court

As discussed above, the remedies for unfair preference and fraudulent trading during the period of the "twilight zone" can be grouped into three aspects: administrative, civil and penal.

Administrative liabilities: In a socialist market economy, administrative sanctions as a distinctive feature of the contemporary Chinese legal system, are more commonly used than in other jurisdictions.[25] With respect to unfair preference or fraudulent trading, the legal representative and the directly responsible persons of the bankrupt enterprise shall be subject to administrative sanctions under Article 41 of the SOE Bankruptcy Law, which may include fine, rank reduction, and dismissal.

Civil remedies mainly focus on (a) setting aside unfair preference or fraudulent transactions and recovery of the property concerned; and (b) holding responsible directors liable to the company.

During the "twilight zone", the liquidation committee, the company, the relevant state authorities, or the third party all has the right to certain extent to apply to the People's court to avoid the transaction and recover the property concerned. The authorities in this regard include Article 35 of the SOE Bankruptcy Law; Articles 63, 118, 214 and 215 of the Company Law; Article 106 of the General Principles of Civil Law and relevant provisions adopted by the State Council and the Supreme People's Court as aforementioned. For example, Article 63 of the Company Law mandates a director to pay compensation to the company for losses caused in violation of the law, administrative regulations and article of association of the company during performance of their duties.

Under Article 118 of the Company, directors shall be responsible for the severe loss of the company caused by any resolution in violation of the law, administrative regulations and the article of association, causing severe damages

[24] For a comment of this case in English, see Xian Chu Zhang, "Practical Demands to Update the Company Law", *Hong Kong Law Journal,* part 2 (1998), at 248-260.
[25] Article 1 of SOE Bankruptcy Law states that the law is formulated in order to promote the development of the planned socialist commodity economy.

to the company, unless they can prove their objection to the adoption of the resolution, which should be recorded in the minute of the board meeting.

The current legal rules also empower the People's Court as a state organ to take action by itself to recover the relevant assets. Article 40 of the SOE Bankruptcy Law, for example, stipulates that the People's Court shall recover the assets if the unfair preference transaction is discovered within one year of the conclusion of the bankruptcy proceeding and make distribution among the creditors in accordance with the priority order as provided by the law.

Penal remedies imposed on the directors of SOEs or state companies include fine, criminal detention, and imprisonment up to seven years for their self-dealing, gross negligence or seeking personal gains at the cost of the state firms.[26] However, these articles may only apply to state owned entities. For companies of other ownership Articles 271 and 272 of the Criminal Law may be invoked, which stipulate that staff of a company may be penalized with confiscation of personal assets, criminal detention or imprisonment up to ten years if he takes advantages of his position to misappropriate the assets of the company.

In addition to the penalties mentioned above, disqualification may also be used as a punishment. According to Article 57 of the Company Law, for instance, a person who served as a director of bankrupt enterprise or company and personally responsible for its insolvent liquidation due to poor management, shall not be appointed as a company director, supervisor and manager for three years of the date of the conclusion of the bankrupt proceedings.

QUESTION 7

7. Duty to co-operate

The SOE Bankruptcy Law sets out the rules governing the directors' duty to cooperate with the liquidation committee during the liquidation period. First, under Article 8 (2) when the debtor enterprise submits the bankruptcy application, it shall explain the conditions of its losses and deliver relevant accounting books, a detailed list of liabilities and accounts receivable to the People's Court.

Second, Article 13 (3) mandates the legal representative of the debtor enterprise, namely the general director of the SOE or chairman of the board of the company, must attend the creditor's meetings and under the legal duty to answer the creditor's inquiries. If he refuses to attend, the People's Court may carry out a mandatory summon in accordance with the Civil Procedure Law.[27]

Third, according to Article 27, the legal representative of the bankrupt enterprise shall be responsible for the taking custody of the property, account books,

[26] Articles 165-169 of the Criminal Law.
[27] Article 32 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Enterprise Bankruptcy Law of November 7, 1991.

documents, materials, seals, etc. of such an enterprise before they are handed over to the liquidation committee. Fourth, before the conclusion of the bankruptcy proceedings, the legal representative of the bankrupt enterprise shall carry out the duties according to the requirements of the People's Court or the liquidation committee, and may not leave his position without authorization. The Supreme People's Court held that an offence may be committed if the legal representative leaves before the conclusion of the bankruptcy proceedings without authorization, or avoids his duties in any other ways, or refuses to carry out transfer procedure to the liquidation committee. The Court may impose fine, detention or other criminal penalties according to the severity of the conduct.[28]

Fifth, after the bankruptcy order is made, the former legal representative of the bankrupt enterprise shall continue to be under a legal duty to organize the accountants of the enterprise to finalize all the account, other relevant people to make the detailed property list, and business staff to clear their business. Upon completion, the legal representative shall transfer all these work to the liquidation committee.[29]

Finally, all the employees of the bankrupt enterprise may also under a legal duty to safeguard its assets during the liquidation. Once the bankruptcy case is accepted by the People's Court, it shall make a public notice to all the employees, requiring them to protect the enterprise assets and to prevent the account books, documents, materials and seals from being unlawfully disposed and the assets from being concealed, partitioned, transferred without consideration or sold below value.[30] Further, after the bankruptcy order is made, the People's Court may ask the legal representative and certain other staff from financial, statistical, warehouse and security departments to stay behind to take care of unfinished matters. Once the order is so made, they have no choice, but to follow.[31]

In addition to the debtor enterprise and its staff, other persons or entities may also owe a duty to be cooperative during the liquidation process. Article 25, for example, states that no unit or individual may illegally dispose of the property, account books, documents, materials, seals, etc. of a bankrupt enterprise. The debtors of a bankrupt enterprise and persons in possession of the property of the bankrupt enterprise shall repay their debts or deliver the property only to the liquidation committee.

As in many other areas, in the "twilight zone" the People's Court has a broad power to investigate into a dispute and to enforce duties to cooperate. Although the SOE Bankruptcy Law and the Company Law contain little specific provision on this regard, the rules of the Civil Procedure Law may always come to help. Under Chapter 10 of the Law, the People's Court may resort to compulsory measures to force relevant persons to appear before the Court, to participate in litigation and to assist the investigation.[32] Article 65 of the Law provides that the People's Court is empowered to investigate into, and obtain evidence from, any entity or individual, who shall not refuse. Article 70 imposes a legal duty on any entity or individual

[28] *Ibid.,* Article 20.
[29] *Ibid.,* Article 54.
[30] *Ibid.*
[31] *Ibid.,* Article 49.
[32] In particular, see Articles 100, 102 and 103 of the Law.

who has knowledge of the relevant fact to testify before the Court. The latest version of the Draft Enterprise Bankrupt and Reorganization Law of the PRC has more specific provisions in the respect of mandatory cooperation in liquidation period. However, in China the underdeveloped evidence regime includes few rules on cooperation defense, such as privileged communication.

With regard to the applicable human rights law in the "twilight zone" period, not much can be found from the current regime. The Chinese laws do not definitely address the concept of self-incrimination when it concerns with the privilege. Although the Criminal Procedure Law of China explicitly stipulates that no person shall be found guilty without being tried by the People's Court,[33] the Law mandates all the suspects to answer all the investigation questions truthfully if they are relevant to the case[34] and restricts their access to lawyers.[35]

Nevertheless, this does not mean that no human right law is available for criminal proceedings in China. To match with the aim to protect the citizens' personal rights, their property rights, democratic rights and other rights,[36] this Law contains several provisions that safeguard the fundamental rights.[37] A director may rely on these articles to protect his lawful rights.

With respect to the international convention relating to human rights, China became a signatory to the International Covenant on Civil and Political Rights in 1998. However, the National People's Congress has not ratified it yet today.

QUESTION 8

8. Appeals and limitation periods

Generally, according to Articles 135 and 137 of the General Principles of Civil Law the statutory limitation of civil actions shall be two years running from the time of infringement or the time the injured party knows or should know the infringement. This period in nature may be a variable period due to suspension[38] or

[33] Article 12 of the Criminal Procedure Law.
[34] *Ibid.,* Article 93.
[35] Article 33 of the Criminal Procedure Law stipulates that the suspect may not appoint his lawyer until the Public Security Office has completed its investigation and has transferred the case to the People's Procuratorate for prosecuting.
[36] Article 2 of the Criminal Procedure Law.
[37] For example, a defendant shall have the right to defense, and the People's Courts shall have the duty to guarantee his defense under Article 11. See also Articles 12, 14, 32, 43, 46,48, and 93 of the Criminal Procedure Law.
[38] According to Article 139 of the General Principles of Civil Law, a limitation of action shall be suspended during the last six months of the limitation if the plaintiff cannot exercise his right of claim because of force majeure or other obstacles. The limitation shall resume on the day when the grounds for the suspension are eliminated.

interruption.[39] However, under Article 137 the People's Court shall not entertain a civil action if 20 years have passed since the infringement. The 20-year-period is in nature invariable period and no suspension or interruption applicable.

Bankruptcy laws and regulations also set out some limitations applicable to bankruptcy and liquidation proceedings. With respect to an unfair preference transaction by the bankruptcy enterprise discovered within one year of the conclusion of the bankruptcy proceedings, the People's Court shall recover the property and order repayment in accordance with Article 40 of the SOE Bankruptcy Law. The Draft Enterprise and Reorganization Law further extends this period to two years.[40]

Moreover, as aforementioned the State Council and the Supreme Court have adopted rules to recover assets of fraudulent transactions and to punish responsible persons without specific time limitation.[41] Although these rules may be considered temporary measures against bankruptcy fraud in a transitional period from a planned economy to a market-centered economy, they will have important impacts in many legal actions in the future.

Currently, there is no special limitation period applying to actions against directors and other officers in the SOE Bankruptcy Law and relevant legislation. As a result the normal limitation of civil and criminal actions shall be applied to these actions. At the same time, Chinese laws are silent in the time frame of the disqualification proceedings as well as its appeal procedures, although the Company Law stipulates the disqualification mechanism against responsible directors and officers. As such, a set of detailed rules needs to be adopted to ensure the due process.

Where directors and other officers' acts constitute criminal offence, the limitation period prescribed in the Criminal Law of PRC shall apply. In accordance with article 87 of the Criminal Law of PRC, crimes are not to be prosecuted where the following periods have elapsed:

- In cases where the maximum legally-prescribed punishment is fixed-term imprisonment of less than five years, where five years have elapsed;
- In cases where the maximum legally-prescribed punishment is fixed-term imprisonment of not less than five years and less than ten years, where ten years have elapsed;
- In cases where the maximum fixed-term imprisonment is not less than ten years, where fifteen years have elapsed;

[39] Article 140 of the General Principles of Civil Law provides that a limitation of action shall be discontinued if suit is brought or if one party makes a claim for or agrees to fulfillment of obligations. A new limitation shall be counted from the time of the discontinuance.
[40] Pursuant to Article 147 of the Draft, within two years after the close of insolvency case, creditors may request the people's court to carry out additional distribution according to the distribution scheme if any property supposed to be recovered from unfair preference. In spite of this, additional distribution shall not be undertaken if the amount of the property is too limited to be distributed.
[41] See *supra* notes 3 and 4.

- In cases where the maximum punishment prescribed by the law is life-imprisonment or death, where twenty years have elapsed. [42]

Thus, the legally-prescribed punishment periods should be firstly decided according to relevant articles in order to make the limitation periods applying to criminal actions against directors clear.

With respect to actions against directors, there is no specific provision governing their appeals. Thus, their appeals against the decision of the first instance court in civil and criminal proceedings shall be governed by the relevant procedure laws.

Under Article 147 of the Civil Procedure Law, if a party refuses to accept a Judgment of first instance of a local people's court, he shall have the right to file an appeal with the people's court at the next higher level within 15 days after the date on which the written Judgment is served. Where a party refuses to accept a written order of first instance of a local people's court which normally is used to deal with procedural matters, he shall have the right to file an appeal with a people's court at the next higher level within 10 days after the date on which the written order is served.

If the defendant in a criminal proceeding refuses to accept a Judgment or order of first instance court, he shall have the right to appeal in writing or orally to the People's Court at the next higher level according to Article 180 of the Criminal Procedure Law. The time limit as set out in Article 183 of the Law for an appeal or a protest against a Judgment shall be ten days and the time limit for an appeal or a protest against a procedural order shall be five days. The time limit shall be counted from the day after the written Judgment or order is received.

An administrative proceeding may also be commenced by an enterprise against a government authority for unlawful interference with its business autonomy. The party concerned may first require the state department to reconsider its decision under the Administrative Reconsideration Regulation of 1994. Article 36 entitles the party to file an administrative action based on Administrative Procedure Law of 1989 within 15 days upon receiving the decision of the reconsideration if he disagrees with the decision. According to Article 58 of the Law, the party may further appeal his case to the next higher level of the People's Court within 15 days after being served with the Judgment of the first instance court.

[42] The period for prosecution is counted as commencing on the date of the crime. If the criminal act is of a continuous or continuing nature, it is counted as commencing on the date the criminal act is completed. See Article 89 of the Criminal Law.

QUESTION 9

9. Foreign Corporations

"Foreign Corporation" is defined in Article 199 of the Company Law as "a corporation that is established according to foreign laws in a foreign jurisdiction". There is no laws or regulations specifically applicable to the bankruptcy liquidation of foreign corporations in China at present.

The Company Law fails to address any cross-border insolvency issue, but only briefly deals with winding up of branch of foreign companies. Article 203 provides that a branch of a foreign company shall not have a legal person status and the foreign company must be responsible for all the liabilities the branch incurred in China. Article 205 in particular states that liquidation in accordance with the law must be conducted when the foreign branch is withdrawn from China. The assets of the branch shall not be moved outside China before the completion of the liquidation.

Moreover, although there is no specific provision on whether transactions in the "twilight zone" applicable to foreign corporations, the rules of directors' duties and responsibilities shall be generally applicable to the business operation of foreign companies in China. Further, Article 204 of the Company Law stipulates that a branch of foreign company shall abide by the laws and regulations of China and shall not harm the social public interests of the nation. It can be inferred from this article that directors of foreign companies may be held liable if they commit unfair preference or fraudulent trading causing damages to the creditors or the interests of China.

As far as foreign investment enterprises in China are concerned, the law treats them as Chinese legal entities since they are registered in China. The Civil Procedure Law, Chapter 19 governs the debt repayment and bankruptcy procedures of enterprise legal persons other than SOEs and companies. As such, bankruptcy of wholly foreign owned enterprises should be governed by this set of rules. However, the entire chapter includes only 8 short articles and the Supreme People's Court had to instruct the lower courts to make reference to the provisions of the SOE Bankruptcy Law when necessary.[43]

In addition, the sensitivity of foreign investment does see some special regulations. For example, the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") promulgated the Liquidation Measures of Foreign Investment Enterprises on July 9, 1996, which is only applicable to foreign joint ventures and wholly foreign owned enterprises in China. Under Article 2, however, the Measures shall not govern insolvency liquidation. Despite its limited application, Article 28 copies the provision of the SOE bankruptcy Law concerning unfair preference. Article 46 further holds the investor liable for unfair preference by way of restitution and compensation.

[43] Article 253 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Civil Procedure Law of July 14, 1992.

QUESTION 10

10. Insurance

No liability insurance for directors' and officers' is available in China at present although such professional liability insurance for lawyers and accountants has recently been marketed as a new device to control business risks in China.[44] The failure to launch liability insurance of directors and officers in China primarily relates to the current legal and business environment. Under the Company Law, directors are more considered to refer to a collective liability, rather than individuals. Also, the underdeveloped corporate governance and excessive government involvement may sound too risky for insurance firms to get into the area. In addition, the inadequacy of relevant insurance legislation gives rise to the difficulties in quantum of compensation concerning liability insurance.
But the situation in this respect is changing now. In a recent meeting jointly held by the Chinese Securities Regulation Commission (CSRC) and Chinese Insurance Regulation Commission (CIRC), a proposal to establish the liability insurance for directors and officers of the listed companies has been put forward. The People's Insurance Company of China (PICC), the biggest non-life insurance company in China, has recognized the urgent need to launch the liability insurance and is preparing to offer the new insurance product. Thus, it is expected that the directors' liability insurance becomes available on the Chinese market in the near future.

QUESTION 11

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

The SOE Bankruptcy Law and other legislations do not prohibit an enterprise from incurring further debts after entering into the "twilight zone" so long as they are not unfair preference or fraudulent transactions as prescribed in Article 35 of the Law or permitted by the relevant state authority, liquidation group or the People's Court if the debts are incurred after the commencement of the bankruptcy proceeding. According to the SOE Bankruptcy Law and the Civil Procedure Law, insolvency of a debtor is primarily determined on a cash-flow basis.[45] As a result, in case where

[44] With respect to the development of insurance system, China has traditionally paid much attention to the property insurance and life insurance, ignoring the liability insurance.
[45] Article 3 of the SOE Bankruptcy Law provides that enterprises that, owing to poor operations and management that result in serious losses, are unable to repay debts that are due to shall be declared bankrupt. According to Article 199 of the Civil Procedure Law, if an enterprise as legal person is in serious losses and unable to repay the debts that are due, the creditors may apply to a people's court for declaring the debtor's bankruptcy repayment, the debtor may also file at a people's

the debtor is able to raise further fund by selling its assets or receiving emergency loan during the twilight period so as to avoid its being declared bankrupt in a short time, the transactions may not go against the spirit of the Laws. The Supreme People's Court in its judicial interpretation also allow the liquidation group to continue to honor any contract it wishes.[46] Based on the rules examined previously, the tests apparently focus on the fairness of the transaction terms and the authorization procedure.

In deciding the liability, the knowledge of a director concerned may also be relevant. It thus is necessary for a director to be continuously informed of the operational and financial conditions of the company so that he could decide an informed decision on whether or not to incur certain debts, especially when these debts are likely to be scrutinized in the "twilight zone". This is because the commencing date of the twilight light zone is not certain until the People's Court accepts the case.

Transactions with the enterprise other than unfair preference prescribed in Article 35 of the SOE Bankruptcy Law during the "twilight period" should be valid. The tests of fairness of the transaction and the necessary authorization procedure shall be equally considered by a third party while dealing with a company in the "twilight zone" period. Further, the recovery from these transactions by a third party will be negatively affected if he knows or should have known about this company's risky financial conditions.[47]

court to declare bankruptcy repayment. Although the bankruptcy reasons contained in these provisions are arguable and subject to criticism in China, they adopt in general the cash-flow test.

[46] Article 55 of the Opinions of the Supreme People's Court on Issues Concerning Implementation of the Enterprise Bankruptcy Law of November 7, 1991.

[47] There is no direct provision in this regard in the SOE Bankruptcy Law and the Company Law. But Article 130 of the Draft Bankruptcy and Reorganization Law provides that a set-off shall not apply if an obligor to the bankrupt obtains an obligatory claim against the bankrupt with the knowledge of the bankrupt's cession of payment or application for bankruptcy. This means that the obligatory claim shall not be set-off and accordingly, the counter-party only could participate in the bankruptcy proceeding for the distribution.

Notes

Egypt

Introduction

Under the Egyptian legal system, there is no comprehensive legal framework regarding the duties and liabilities of directors of commercial companies. Basically such duties and liabilities are left to be decided by the mutual agreement of the partners or the owners of the company, provided that such agreement should be compatible with general mandatory rules of law. Nevertheless in the absence of an agreement such duties and liabilities shall be subject to the Egyptian Civil Code (Articles 516-520). It should also be noted that these duties and liabilities vary according to the different type of commercial company in question. Under Egyptian law six types of commercial companies exist: -

1. General Partnership.
2. Limited Partnership.
3. Particular Partnership.
4. Partnership limited by shares.
5. Limited liability company.
6. Joint stock company.

According to Egyptian Law there is a distinction between the terms “Insolvency” and “Bankruptcy”. The term “Insolvency” refers to the civil person’s inability to pay his debts while the term “Bankruptcy” refers to moral or physical persons enjoying commercial character when they stop paying their commercial debts. Civil persons are subjected to less stringent rules than the rules of bankruptcy applicable to “merchants”.

The following persons are considered “merchants” according to article (10) of the Egyptian trade law:

1. All persons professionally exercising in their name and on their account a commercial activity; and
2. All types of companies whatever its purpose is

Under Egyptian law, only joint partners are considered merchants since they are personally liable for the company’s debts in all their fortunes. Other partners are not considered as Merchants since they are only liable for the company’s debts in proportion to their shares. This paper is confined to the rules of bankruptcy of merchants.

A draft of a “Unified Law of Companies”, has been recently prepared, and may soon be issued. The most important feature of this draft is that it has integrated all the different types of companies whether civil, commercial or investment companies, and it has also acknowledged the “One man’s company” as one of the types of commercial companies.

Following the Constitutional Amendment of 1980, Shariaa became the primary source of Egyptian Legislation. However, due to the liberal interpretations of Shariaa Rules and Principles which were adopted by the legislative committees, flexible rules of law were issued. Modern Legislation drove away from the old traditional views of Shariaa Jurists. Legislation compatible with Shariaa spirit and concepts and at the same time capable of facing the recent developments in transactions, and in society in fields such as banking, insurance companies and joint ventures were issued in a way that would not differ from Western approaches. As for interest rates, regarded by some traditional Shariaa jurists as forbidden Usury, moderate jurists allow interest. Egyptian legislation permits interest in both civil transactions (4%) as well as commercial transactions (5%) and may also provide for interest as determined according to the rate set up by the Central Bank.

According to these rules Egyptian courts apply and adjudicate such interest as provided for by the law.

QUESTION 1

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

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

1.1 The Twilight Period starts from the date when a company stops paying its debts, and lasts until a final adjudication of bankruptcy is issued by the competent court, which has discretionary power to determine the date on which payment of debts was stopped. Consequently, although the start of the Twilight Period does not depend on the commencement of a formal insolvency procedure its duration does.

Thus, a trader shall be considered in a state of bankruptcy if he stops paying his commercial debts following disturbance of his financial affairs. However, discontinuance of payment shall produce no resultant effect before a court ruling declares him bankrupt. (Article 550 of Law no 17 of Trade Law issued by Law no.17/1999)

1.2 Moreover, A trader may be declared bankrupt after his death or retirement if he died or retired from trade while in a state of discontinued payments. The request for a declaration of bankruptcy must be submitted during the year following the death or retirement from trade business. This period shall not begin to apply, in the case of retirement , except from the date of deleting the name of the trader from the Commercial Register. (Article 551 of the Trade Law)

1.3 The court shall determine in the bankruptcy declaration ruling a temporary date for discontinuing the payments. (Article 561 of the Trade Law)

If in the bankruptcy declaration ruling the date on which the debtor discontinued paying is not defined, the date on which the bankruptcy declaration ruling is issued shall be considered a temporary date of discontinuing the payments.

However, if the bankruptcy declaration ruling is pronounced after the death of the debtor or after his retirement from trade business, without defining the date of discontinuing the payment, the date of his death or retirement from trade business shall be considered a temporary date of discontinuing payments.

It should be noted that in defining the date of discontinuing the payment, the court shall make use of each deed, statement of act issued from the debtor and revealing a disturbance of his works or his attempts to continue his trade activity

by illegal means or harmful methods to his creditors. This will include an attempt by the debtor to escape or commit suicide, hide his property or sell property at a loss, conclude loans with oppressive terms or enter into irrational speculations. (Article 562 of the Trade Law)

The court may, on its own, or upon the request of the Public Prosecution, the debtor, one of his creditors, the trustee of the bankruptcy or other interested parties, modify the temporary date of discontinuing the payment to the date of ten days after the date of depositing a list of the funded debts with the clerks office of the court, and after the lapse of this period the date defined for discontinuing the payment shall become final.

In all cases, the date of discontinuing the payment shall not be moved back to more than two years prior to the date of issuing the bankruptcy declaration ruling. (Article 563 of the Trade Law)

It is well accepted that the start and duration of the Twilight Period depends on the nature of the transaction.

The trader shall not be declared bankrupt because of discontinuing the payment of the criminal fines, taxes, duties, or social insurance due on him. (Article 555 of the Trade Law)

1.4 The law provides that the issue of the bankruptcy declaration ruling shall fetter the hands of the bankrupt from managing and disposing of the property. The dispositions made by the bankrupt on the day the bankruptcy declaration ruling is issued shall be considered as made after the issuing of the ruling.

Fettering the bankrupt's hand from managing and disposing of his property and funds shall not prevent him from taking the necessary procedures toward maintaining and preserving his rights. (Article 589 of the Trade Law)

Accordingly a bankrupt, after the bankruptcy declaration ruling is pronounced, shall not settle his debts, nor receive his due rights. However, if the bankrupt holds a commercial paper, its value may be settled to him at its due date, unless the bankruptcy trustee objects to such settlement. (Article 590 of the Trade Law)

It is to be noted that after the bankruptcy declaration ruling is pronounced, no clearing arrangements shall take place between the bankrupt's due rights and his obligations unless a link connects them together. This linkage exists particularly if the rights and obligations arise from one reason, or a current account comprises them. (Article 591 of the Trade Law)

1.5 However, hand binding shall comprise all property owned by the bankrupt on the day the bankruptcy declaration ruling is pronounced, and the property of which the ownership devolves to him while he is in a state of bankruptcy, but it should be noted that hand binding shall not comprise the following :

(a) The property on which no attachment is legally permissible, and the allowance determined for the bankrupt.

(b) Property which is not owned by the bankrupt.

(c) Rights connected with the person of the bankrupt or his personal status.

(d) Compensations payable to the beneficiary in a valid insurance policy concluded by the bankrupt before the issue of the bankruptcy declaration ruling. However, the beneficiary shall refund to the bankruptcy all insurance premiums the bankrupt paid from the date the court appoints to discontinue the payment, unless otherwise prescribed in the law. (Article 592 of the Trade Law)

1.6 It should be taken into consideration that the following disposals of a debtor's property shall not be enforceable vis-à-vis the group of creditors, if such disposals are made after the date of discontinuing the payment and before issuance of the bankruptcy declaration ruling :

(a) Granting donations in whatever form with the exception of small presents offered according to usage and practice.

(b) Settling debts before their maturity date, whatever the method of settlement. Establishing a consideration amount for settlement of a commercial paper not prior to its maturity shall be treated as formal settlement before the maturity date.

(c) Settling due debts with other than the object agreed upon. Payment by means of commercial paper or bank transfer shall be treated as settlement with money.

(d) All pawn or other consensual deposit, as well as all liens to be determined on the debtor's property as a guarantee for a debt prior to the deposit. (Article 598 of the Trade Law)

1.7 If the other party to the transaction is connected or associated with the bankrupt company, this may cast doubts on the transaction and the court accordingly may consider any disposal related to him is not insisted upon. However, if any of the acts that is considered as a crime according to the Penal Code and the rules of the bankruptcy as noted below and if the crime is connected with an agreement concluded by the debtor or any person with one of the creditors to grant this creditor special benefits (particular lien) in return for voting in favour of composition, the criminal court may, motu proprio, pass a judgment decreeing the nullification of this agreement and compelling the creditor to refund whatever he laid hold of by virtue of that agreement, even though the court might acquit him.

The court, upon the request of the concerned parties, may also pass a judgment decreeing the payment of compensation if necessary. (Article 772 of the Trade Law)

QUESTION 2

2. Actions Potentially Giving Rise to Liability of Directors:

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

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

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

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

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

(iv) Is there a specified period before commencement of a subsequent insolvency liability to attach to a director? ; and

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

2.1 Once the adjudication is issued, the director shall be restrained from managing and disposing of the company's property, except for the procedures or acts necessary for maintaining and preserving the company's rights as mentioned above.

Following the adjudication of insolvency, the court shall appoint a bankruptcy trustee (receiver). The trustee once appointed becomes responsible for the management and maintenance of the property of the bankruptcy, and deputizing the company in all actions and works necessary. (Article 573 of the Trade Law)

2.2 Acts, which may potentially give rise to liability of directors, can be classified into the following catagories:

(a) Acts which may give rise to criminal liability of the directors

In order for directors to incur criminal liability, they must commit one of the bankruptcy crimes. Under the Egyptian Penal Code, bankruptcy may amount to a number of Criminal Offences, regulated under Articles (328-335 of the 1937 Penal Code no. 58 of 1937). Generally speaking these Offences may be classified into:

(i) Crimes of fraudulent insolvency: punished by 3 to 5 years of imprisonment. The following acts are examples for crimes of fraudulent insolvency with each considered a felony.:

1.Falsification of the company's' books,
2.Embezzlement of or hiding part of the company's money.
3.Fraudulent Transactions.

(ii) Crimes of negligent insolvency: Crimes of negligent insolvency are punished by 2 years imprisonment, and constitute a misdemeanor.

Wrongful trading, preference, and negligently holding the company's books are considered examples of negligent insolvency

(b) Acts which may give rise to personal liability of directors

Directors are personally liable under Egyptian law in all of their fortunes due to financial losses suffered by the company if they are partners in the company.

Thus, according to Article (703) of the Trade Law if the company is declared bankrupt, all its joint partners including director partners shall be declared bankrupt. This shall comprise declaring the bankruptcy of the joint partner who resigned after the company discontinued its payments, if the request to declare the bankruptcy of the company is submitted within one year from the date the partner is registered in the commercial register as having resigned from the company.

If a bankruptcy petition is submitted for the company, the court may also pass a judgment in bankruptcy for all persons who under cover of this company carry out commercial operations for their own account, and disposes of the company's funds and property as if they were their own.

However, if it transpires that the company's assets are inadequate to settle at least 20% of its debts, the court, upon the request of the bankruptcy judge, may decree that all or some of the board members or directors, jointly among themselves or severally, shall pay all or part of the company's debts, unless they establish that they exerted in running the company's affairs, the same care as that of a keen and careful person.

Moreover, the court, motu proprio or upon the demand of the bankruptcy judge, may pass a ruling decreeing the forfeiture of some of the rights to vote or be elected, of the company's board members or directors who have committed serious errors leading to confusion of the company's works and discontinuation of its payments. (Article 704 of the Trade Law)

(c) Acts which may give rise to civil liability to directors

Under this classification, any act that has caused a material or moral loss to the company or to any other person and was due to the wrongful conduct of the director, shall make him liable. In such a case the director's liability will be subject to general rules of Tortious Liability in the civil law, article (163).

2.3 Defences

Defences related to crimes require that bad faith (mens rea) should be proved. Such evidence is subject to the discretionary power the judge enjoys regarding evidence evaluation.

Defences related to negligent insolvency are subject to the basic criterion of “The reasonable man” and principles of tortious liability under civil law (art. 163).

Thus, defences may be accepted or refused according to the discretionary power of the judge in the light of the above mentioned rules and criteria.

QUESTION 3

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3. Other Persons involved with the Company’s Affairs that May Become Liable in Respect of their Actions During the Twilight Period.

3.1 As noted above partners, co-partners, shadow directors, de facto directors and former directors may become liable according to Article 703 of the Trade Law which provides that if the company is declared bankrupt, all joint partners thereof shall be declared bankrupt. This shall comprise declaring the bankruptcy of any joint partners who resigned after the company discontinued its payments, if the request to declare the bankruptcy of the company is submitted within one year from the date the partner is registered in the commercial register as having resigned from the company.

The court shall pass a ruling in which it pronounces the company's declared bankruptcy together with the declaration of the bankruptcy of the joint partners, even though it may not be concerned with declaring the bankruptcy of these partners.

The court shall appoint for the bankruptcy of the company and the bankruptcies of the joint partners one judge and one trustee or more. However, each bankruptcy shall be independent from the others in terms of its assets and liabilities, as well as its management, the funding of its debts, and its termination.

3.2 As for banks, third parties with knowledge of insolvency of the company and a person knowingly dealing with a director abusing his/her powers, it is important to note that their disposals may not be insisted upon vis-à-vis the group of creditors. Following are the types of disposals that shall not be insisted upon vis-à-vis the group of creditors :

(a) Granting the donations, whatever their kind is, with the exception of small presents offered according to usage and practice.

(b) Settling the debts before their maturity date, whatever the method of settlement. Establishing a consideration amount for settlement of a commercial paper not yet maturing shall be considered as good as settlement before the maturity date.

(c) Settling the due debts with other than the object agreed upon. Payment by means of the commercial paper, or bank transfer shall be considered as good as settlement with money.

(d) All pawn or other consensual deposit, as well as all lien to be determined on the debtor's property as a guarantee for a debt prior to the deposit. (Article 598 of the Trade Law)

However, a court ruling may be issued for non-execution of all disposals by the bankrupt, other than those mentioned above, during the period referred to therein, vis-à-vis the group of creditors, if the disposal is harmful to it and the party disposed to was at the time of that disposal, aware of the bankrupt's discontinuance of payment. (Article 599 of the Trade Law)

QUESTION 4

4. Counterparties dealing with the company during the twilight period

See response to question 2.

QUESTION 5

5. Enforcement

By who may actions be brought against-directors?

5.1 In the light of what was mentioned above:

(a) Actions may be taken directly by the court as noted above.
(b) Actions may be bought by the trustees, or the controllers.
(c) Actions may be brought by creditors or persons having legal interests within the limits prescribed by law.
(d) Actions also may be brought by the prosecutor (District Attorney)

QUESTION 6

6. Remedies: orders available to the domestic court

See response to question 2.

QUESTION 7

7. Duty to co-operate

To what extent are directors obligated to co-operate with the investigation into the company's affairs following its insolvency.

Once the bankruptcy decision is issued the bankrupt or the director is to co-operate with the investigation into the company's affairs especially in the following:

(a) The director should not hide any documents, papers or clarifications that may lead to fraudulent insolvency which may result in imprisonment of between 3 to 5 years. (Article 328 of the Penal Code)

(b) On the other hand, the company's directors are under a duty to submit its commercial books upon the court order, and the court has the discretionary power to sentence a director with a daily default fine.

(c) The director should attend when called the session of closing the commercial books. (Article 640 of the Trade Law)

According to the Constitution, and the law of evidence a person may not be obliged to submit self incriminating evidence. However, this is not the case if the bankrupt or the director hides books, documents or information that led to fraudulent bankruptcy.

QUESTION 8

8. Appeals and limitation periods

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

(b) Is an appeal available from the decision of the lower courts?

8.1 Limitation periods

Limitation periods for penal proceedings

According to the Egyptian procedural penal code, the limitation period for the offence of fraud bankruptcy, which constitutes a felony, is ten years. Thus, when the period of ten years expires without bringing the action it may not be brought before the court .On the other hand, the limitation period for binging an action in the misdemeanor of the bankruptcy by negligence is three years.

Limitation period for proceedings in which compensation is to be sought

Generally speaking, a compensation claim may rest upon principles of tortious liability or principles of contractual liability.

If the compensation claim is based upon tortious liability principles then the limitation period shall be fifteen years from the date the loss or damage occurred. On the other hand, limitation periods for compensation claims based upon principles of contractual liability, are fifteen years.

However, court actions arising from the application concerning some disposals, shall abate after the lapse of two years from the date of issuing the bankrupt declaration ruling. Examples of this include:

(a) Making donations, of whatever kind, with the exception of small presents offered according to usage and practice.

(b) Disposals or settling debts before their maturity date, whatever the method of settlement. Establishing a consideration amount for settlement of a commercial paper prior to maturity shall be considered as settlement before the maturity date.

(c) Disposals of settling the due debts with other than the object agreed upon. Payment by means of the commercial paper, or bank transfer shall be considered as settlement with money.

(d) Disposals of pawn or other consensual deposit, as well as all liens to be determined on the debtor's property as a guarantee for a debt prior to the deposit. (Article 604 of the Trade Law)

8.2 Appeals against decisions of the first instance court

Each interested party, other than the litigants, may object to the bankruptcy declaration ruling in the court issuing it within thirty days from the date of publication in the papers, unless it was appealed against in which case the objection shall be raised to the court examining the appeal.

The period for objection to all rulings issued in court actions as a result of the bankruptcy shall be thirty days from the date of their issue, unless they are due for publication in which case the period shall begin from the date of publication.

The provisions of the Civil and Commercial Procedure Law shall apply to the rulings issued in bankruptcy declaration actions and other rulings issued in court actions resulting from the bankruptcy and the method of lodging them. (Article 565 of the Trade Law) The period for appeals in these cases is 40 days.

It should also be mentioned that the rulings issued in bankruptcy actions shall be due for self- execution without bail, unless otherwise prescribed. (Article 566 of the Trade Law)

However, no contestation shall be instituted in any way against:

(a) The rulings or decisions concerning the appointment or replacement of the bankruptcy judge, trustee, or controller.

(b) Rulings as issued in the objection against the decisions of the bankruptcy judge.

(c) Orders issued cancelling the custody proceedings on the person of the insolvent.

(d) Rulings issued for staying the bankruptcy proceedings until the final decision is taken in the objection lodged against the bankruptcy judge concerning acceptance or refusal of the debts.

(e) Rulings issued concerning acceptance of the litigious debts temporarily.

Appeals against penal proceedings

Appeals against penal proceedings in the case of misdemeanors should be filed within 10 days from the date of issuance or notification of the first instance court decision. Sentences handed down in felony cases are subject to no appeal, but may be submitted to the Court of Cassasion to examine the application of the law within 40 days from the date of issuance or notification.

QUESTION 9

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9. Foreign Corporations
Legal provisions and procedures applicable to foreign corporations

Under Egyptian Law, a foreign company and a branch agency in Egypt are subjected to the same rules as domestic companies. Unless bilateral or a multi-lateral international-convention enforced in Egypt provides otherwise.

QUESTION 10

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10. Insurance

Directors and officers of commercial companies may be insured according to the Egyptian Law and the rules of insurance companies.

However, it is very rare that this happens in practice.

ENGLAND

QUESTION 1

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

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

1.1 Overview

1.1.1 As a general rule, English law focuses on two questions. First, in connection with a range of 'clawback' provisions[1] the key issue is whether the company was 'insolvent' at the time (or as a result) of the relevant transaction. "Insolvent" for these purposes means:

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

(b) the moment at which the company's liabilities exceed the value of its assets - the "balance sheet" test.

1.1.2 The second question relates to the English law concept of 'wrongful trading'. This is discussed in more detail at question 2 below but for current purposes it is sufficient to note that the law tries to identify the time at which a director knew or should have realised that it was unreasonable to think that the company would avoid insolvent liquidation (ie. creditors were likely to go unpaid in due course). From that moment, a director will potentially be personally liable unless he does everything reasonably possible to minimise losses to creditors.

1.1.3 Besides the above statute-based considerations, it is worth mentioning in passing that a director's general duty to act in the best interests of the company has a different content when a company is 'insolvent' (in the sense that its liabilities exceed the assets). In these circumstances, the law recognises the economic reality on the company's position[2] and the directors must exercise their powers and discharge their duties with a view to minimising the potential loss to creditors as opposed to acting in the best interests of the collective body of shareholders.

1.1.4 The twilight period will, as a general rule, terminate when the formal insolvency procedure commences[3].

[1] Laws entitling the insolvency office-holder (such as the liquidator or administrator) to claim assets/monies from third parties - usually in relation to transactions entered into during the twilight period - to boost the pool of assets available to pay dividends to creditors.

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

[3] This will generally be the date on which the petition or other court process was issued upon which the court ultimately made an order that the company enter the insolvency procedure involved or, in

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

(a) preferences (eg. security, charges) - 6 months, or two years if the preferred person is connected (ss. 239 and 240(1)(b)[4]);

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

(c) transactions at an undervalue (eg. guarantees) - two years (ss. 238 and 240(1)(a));

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

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

(f) dispositions after winding up petition - from date of petition (s. 127).

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

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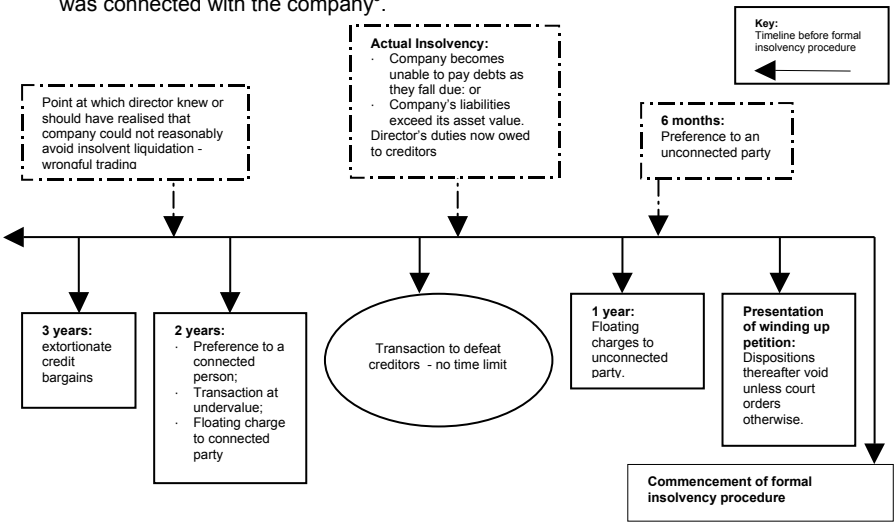
the case of a voluntary procedure, the date on which a resolution was passed by the company to pursue that voluntary procedure.

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

1.1.6 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.

[5] Effectively connected persons comprise directors (or "shadow" directors upon whose information the directors customarily act) or an "associate" of such a director or shadow director. Alternatively, a person is connected if he is simply an associate of the company. A natural person is an associate of another if they are relatives, partners, have an employer/employee relationship or trustee/beneficiary relationship. A company may also be an associate of another company if they are under common control.

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 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;

[6] Section 214 IA 1986

[7] In general terms, English law and practice is thought to support 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.

[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 3.2.1 - 3.2.4.

(ii) it applies where a company has at some point gone into insolvent liquidation (that is where the liabilities exceed the assets in the liquidation so that creditors go at least in part unpaid);

(iii) it applies to a director or shadow director who knew or should have realised that at some point in time there was no reasonable prospect of the company avoiding insolvent liquidation;

(iv) as to what the director should have realised, the law imposes both an objective and a subjective standard. Objectively, the law assumes a minimum standard of skill and care that can reasonably be expected of any director carrying out the functions entrusted to him. Subjectively, the law will take into account the director's particular skills and what can be expected of him in that context in addition to the basic minimum standards;

(v) once it can be said of any director or shadow director that they knew or should have realised that insolvent liquidation was the only reasonable prospect then they are "in the wrongful trading zone" and may be liable for failure to take every step to minimise losses to creditors. Again as regards what is reasonable to expect of a director, the court will look at what minimum standard should be applied to someone carrying out their functions and also at what someone with that director's particular skills could have done.

(b) (i) Liability is civil.

(ii) The court has a wide discretion in determining the extent of the personal liability of a director found liable for wrongful trading. However, the essence of the law is to compensate creditors for the loss caused by the director's conduct.

(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 or secondly that, if insolvent liquidation of the company was the only reasonable prospect, from that moment the director/shadow director took every step to minimise the potential loss to creditors.

2.2 Fraudulent Trading[9]

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

[9] Section 213 IA 1986

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

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

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

(iv) it applies to persons who are "knowingly parties" to the fraudulent trading which may be both wider and narrower than the concept of director/shadow director for wrongful trading, but it could in theory, be wide enough to catch a financier who funded the fraudulent trading knowing that it was being done dishonestly.

(b) (i) Liability may be criminal[10] 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 also include a punitive element in the award of damages made.

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

(iv) There is no specified period.

(v) The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full. It is worth noting that it was rare and remains rare for persons to be found liable for fraudulent trading. Historically, this resulted from the difficulty of proving dishonesty and, now, wrongful trading will in most sets of facts be easier to prove.

2.3 Fraud in anticipation of winding up[11]

(a) Personal liability will attach to an "officer"[12] of the company who has :

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[10] Section 458 Companies Act 1985. Section 213 IA 1986 is concerned only with civil liability.
[11] Section 206 IA 1986
[12] There is no specific definition of an "officer" in either the IA 1986 of the Companies Act 1985. However, section 744 Companies Act 1985 (incorporated into the IA 1986) states that an officer in relation to a body corporate will include "a director, manager or secretary". A "director" is defined in the IA 1986 as including any person occupying the position of a director "by whatever name called". This will therefore include "de facto" directors. Whether a "shadow director" is included within the definition of an "officer" is likely to depend on the specific provision in question. For example, an "officer" is expressly stated to include a shadow director for those offences described in paragraphs 2.3, 2.5, 2.7 and 2.8 but not paragraphs 2.4 and 2.6. Consequently, where a "shadow director" is not expressly stated as being included by the statutory provisions it may be concluded that such a person will not be included as an "officer" for that provision. For an explanation of the definition of a "manager", see footnote 39 to paragraph 3.3.1 below.

(i) concealed or fraudulently removed any part of the company's property worth £500 or more or concealed any debt owed to or from the company;

(ii) concealed, destroyed, mutilated or falsified any accounting records of the company; or

(iii) pawned, pledged or disposed of any property of the company which has been obtained on credit and not fully paid for - unless such disposal was in the ordinary course of business.

(b) If any of (i) - (iii) above are satisfied:

(i) Liability is criminal.

(ii) A person guilty of this offence is liable to imprisonment or a fine or both.

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

(iv) The acts in question must have occurred either :

(A) after the commencement of the winding up; or

(B) within a 12 month period ending with the commencement of the winding up.

(v) The following defences exist :

(A) that there was no intent to defraud or to conceal; and
(B) that there was no intent to defeat the scheme of the insolvency law.

2.4 Transactions in fraud of creditors[13]

(a) This offence is made out if an officer of the company:

(i) has made or caused to be made any gift or transfer of, or charge on, or has caused or connived at the levying of any execution against, the company's property, or

(ii) has concealed or removed any part of the company's property since, or within 2 months before, the date of any unsatisfied judgment or order for the payment of money obtained against the company.

(b) (i) The liability under this provision is criminal and the answers to 2.3(b) (ii) and (iii) above will apply.

(iv) The impugned transaction must have occurred five years before the commencement of the winding up.

[13] Section 207 IA 1986

(v) Absence of intent to defraud the company's creditors amounts to a defence.

2.5 Misconduct in course of winding up[14]

(a) A past or present officer 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.

(iv) 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.

(v) 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[15]

(a) An officer 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:

[14] Section 208 IA 1986
[15] Section 209 IA 1986

(i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.

(iv) This offence applies when a company is being wound up.

(v) Absence of intent to defraud or deceive will amount to a defence.

2.7 Material omissions from statement relating to company's affairs[16]

(a) A past or present officer 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.

(iv) This offence applies to statements made when a company is being wound up.

(v) Absence of intent to defraud is a defence.

2.8 False representations to creditors[17]

(a) Any past or present officer 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.

(iv) This offence applies to false representations made when a company is being wound up.

(v) 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 [18]

(a) An officer of the company 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.

[16] Section 210 IA 1986
[17] Section 211 IA 1986
[18] Section 212 IA 1986

(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[19].

2.10 Re-using a prohibited company name[20]

(a) Any person who was either a director or shadow director of the company at any time during the period of 12 months ending with the company's liquidation is prohibited from being concerned in another company which uses the insolvent company's name or a name similar to that name so as to suggest an association with it. The extent of the prohibition is that, except with the leave of the court, a director is not permitted for a period of five years from the date of the commencement of the relevant liquidation:

(i) to be a director of any company that is known by a "prohibited name";

(ii) in any way, whether directly or indirectly, to be concerned or take part in the promotion, formation or management of such a company; or

(iii) in any way, whether directly or indirectly, to be concerned with or take part in the carrying on of a business carried on (otherwise that by a company) under a prohibited name.

A "prohibited name" is;

(i) a name by which the company which went into insolvent liquidation was known at any time during the 12 months prior to the commencement of the liquidation; or

(ii) a name so similar to that name as to suggest an association with the company in insolvent liquidation (s 216(2)). This would include a trading name as well as a registered name.

[19] Section 727 Companies Act 1985
[20] Sections 216 and 217 IA 1986

(b) (i) Liability is both criminal[21] and civil[22].

(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, such debts and other liabilities of the new company as are incurred at a time when that person was acting on or was willing to act on those instructions.

(iii) Liability may arise where the re-use of the company name took place without the consent of the court during the period of 5 years beginning with the day on which the company went into liquidation if the re-used name is the same as the name used by the insolvent 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 which 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[23];

(B) for an interim period, where an application is made to the court[24]; 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[25].

2.11 Destroying, mutilating etc. company documents [26]

(a) Any officer 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.

[21] Section 216 IA 1986
[22] Section 217 IA 1986
[23] Rule 4.228 Insolvency Rules ("**IR**") 1986
[24] Rule 4.229 IR 1986
[25] Rule 4.230 IR 1986
[26] Section 450 Companies Act 1985

(iv) There is no time period within which the relevant act must have been undertaken in order for liability to attach to a director.

(v) Absence of an intention to conceal the company's state of affairs or to defeat the law is a defence.

2.12 General fiduciary duties owed to the company

(a) It is an established rule that insofar as a director of a company is bound by fiduciary duties under the general law, those duties are owed to the company only. The form in which a director's duties are expressed is that of a number of general legal and statutory rules, varying greatly in the range of application and at many points overlapping with each other. The duties include:

(i) the duty to act bona fide in the interests of the company[27];

(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 duties imposed by various provisions in the Companies Act 1985 as to directors' contracts; and

(vii) the duty not to make secret profits.

Once the company is insolvent, however, the interests of the creditors 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.

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

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

(iii) Liability for breach of general fiduciary duty is joint and several for the entire loss in the first instance. The Court can, however, allocate contributions as between the defendant directors taking into consideration their respective levels of culpability for what has taken place[28].

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

[27] this includes a duty to act in the best interests of employees: s309(1) Companies Act 1985
[28] Section 1, Civil Liability (Contribution) Act 1978

(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[29].

2.13 Common law duties of skill and care

(a) A director in carrying out his duties:

(i) is required to exhibit such a degree of skill as may reasonably be expected from a person with his knowledge and experience or that may reasonably be expected of a person in his position; and

(ii) to exercise such skill and care as an ordinary man would bring to bear on his own affairs.

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

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

(ii) The court will award damages to compensate the company for loss that has been suffered as a result of the director's breach of duty[30].

(iii) Liability for all of the loss suffered by the company because of the breach of duty will be joint and several. The Court can allocate contributions as between the defendant directors based on their respective levels of culpability for the loss.[31]

(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.[32]

[29] Section 727, Companies Act 1985
[30] In *West Mercia Safetywest 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.
[31] Section 1, Civil Liability (Contribution) Act 1978
[32] Section 727, Companies Act 1985

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

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

2.14.2 An executive director will normally have a service contract which may be the source of additional duties. Section 310 of the Companies Act 1985 prohibits any provisions in a contract or in the company's memorandum or articles of association which attempt to exonerate or indemnify the director from liability. It is also not possible to create an exhaustive list in either the director's service contract or in the company's memorandum or articles to specify exactly what are the director's duties. The duties owed by a director to the company can be increased by reference to the terms of the service contract but they cannot be diminished.

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

2.15 Incurring further credit

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

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

2.16.1 The relevant legislation is the Company Directors Disqualification Act 1986 ("**CDDA 1986**"), under which a court may order that a person should be disqualified from being a director of a company or from taking part in its management (except with the leave of the court), for a period of up to fifteen years. While insolvency of the company concerned is not a prerequisite for the application of some of the grounds of disqualification set out in the CDDA 1986[33], in practice almost all disqualification orders are made on the basis of conduct evidencing a person's 'unfitness' to act as director[34], 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

[33] 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).
[34] Section 6 CDDA 1986.

proceedings such as administration or administrative receivership. There is no provision in the CDDA 1986 for the automatic disqualification of a person in any circumstances or for disqualification to be imposed by administrative action without court involvement[35]. Disqualification orders can also be made where the person concerned has been held liable to make a contribution to the assets of a company in liquidation on the grounds of fraudulent or wrongful trading[36].

2.16.2 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. 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.

Acts potentially giving rise to a disqualification order

2.16.3 As noted above, in all but a few instances, the ground on which an order is made is a finding of 'unfitness' based on the person's conduct in relation to one or more companies which have become insolvent. There is no statutory definition of 'unfitness'. Instead, the CDDA 1986 sets out in a schedule a list of typical factors on which a finding of unfitness may be based, such as breach of fiduciary duty by the director (see above), misapplication of moneys and failing to keep proper accounts and make returns. More pertinently, the list also includes various acts which will usually be linked with the company's insolvency – for example, the person's responsibility for the company entering into any transaction liable to be set aside as being at an undervalue, a preference or in fraud of creditors. However, the list of matters referred to in the schedule is not exhaustive, and in practice other types of conduct which commonly feature in disqualification cases include continuing to trade when the director knew, or should have known, that the company was insolvent, failing to account to the Inland Revenue for tax and social security moneys deducted from employees' wages, following a policy of discriminatory payment between creditors, drawing excessive remuneration and making excessive expenses claims.

2.16.4 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.

Length of disqualification

2.16.5 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

[35] However, legislation shortly to be brought into operation will authorise the relevant government officer to accept an undertaking not to act as a director, in lieu of a court order in order to save the parties the trouble and expense of court proceedings.
[36] Section 10 CDDA 1986.

(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;

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

(c) a middle 'bracket' of six to ten years for cases falling between (a) and (b). Statistics show that most of the orders made range from three to seven years.

An appeal is in principle available against the imposition of a disqualification order, or against its duration. In some cases, however, an appeal will lie only with the leave of the court which made the order or of the appeal court itself. As noted in paragraph 2.14.1 above, a disqualification order may be made as part of the sentence imposed by a criminal court, or consequentially upon a finding of fraudulent or wrongful trading leading to an order to pay compensation. But the converse is not the case: where proceedings are commenced for the purpose of obtaining a disqualification order, there is no jurisdiction to impose a criminal or civil penalty in addition.

2.16.6 Other than those who have been formally appointed directors, and save where the conduct on which an order is based is a criminal offence[37] or fraudulent trading[38], orders may only be made against de facto directors, shadow directors and former directors. A financing bank, holding company or other third party (including counterparties to voidable transactions) will not be liable unless its conduct brings it within one of these three categories.

2.16.7 Enforcement is in practice (and, in the case of orders based on 'unfitness', by express provision) almost entirely in the hands of government or regulatory authorities. The only likely exception would be where a disqualification order is made incidentally to a finding of wrongful trading, in which case the proceedings would have been instituted by the company's liquidator. Office-holders, such as liquidators, are placed by statute under an obligation to submit a report to the appropriate government agency on the conduct of every director and former director of a company which has become insolvent, with a view to determining whether there is a case for disqualification proceedings on the ground of unfitness to be instituted.

Duty to co-operate

2.16.8 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-

[37] Section 2 CDDA 1986
[38] Sections 4 and 10 CDDA 1986

operate with him[39] and by other legislation to give information to government officers investigating the affairs of a company. A detailed summary of a director's duties to co-operate and the relevant provisions are set out in question 7 below.

Limitation periods

2.16.9 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.

Foreign corporations

2.16.10 The jurisdiction to make a disqualification order is not territorially restricted, so that an order may be made in an appropriate case against a person who is a foreign national or resident abroad, or who has been a director of a foreign company, or on grounds which include acts committed abroad. Of course, it is necessary that either the company in question or some other company with which the person has been connected is the subject of insolvency proceedings in this country. This issue is dealt with further in response to question 9 below.

QUESTION 3

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

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

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

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

3.1 Introduction

3.1.1 Subject to the particular act or offence in question, English law may impose liability on a potentially wide variety of persons who have been involved in the management of a company in some way during the twilight period. Although the

[39] Sections 235 and 236 IA 1986

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 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 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 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. Secondly, under statute and to catch figures who, although not on the board nor apparently taking day to day decisions at the company, are in fact pulling the strings from behind the scenes, there is the concept of the "shadow director".

De facto directors

3.2.2 A de facto director is one who acts as a director and is treated as such by the rest of the board even though he may never have been formally appointed a director or there is a defect in the technicalities of his appointment (for example he was appointed at a meeting at which a quorum was not present). "Director" is defined in section 741(1) of the Companies Act 1985 to include any person occupying the position of director, by whatever name called. Thus, if someone were to be called an "observer" on the board but in fact took director-type decisions, then the court may be prepared to conclude that that person is a de facto director.

3.2.3 De facto directors owe the same duties to the company as directors who have been formally appointed. However, they may be further liable if they dispose of company property because they are wrongdoers. Unless the shareholders in general meeting resolve to ratify the disposals, they are liable to compensate the

company for the value of the assets wrongfully disposed of. This right of action vests in the company.

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

Shadow directors

3.2.5 A shadow director is defined in section 251 of IA 1986 and section 22(5) of the CDDA 1986 as: "a person in accordance with whose directions or instructions the directors of a company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity)."

There is a similar definition for Companies Act purposes in section 741(2) of the Companies Act 1985.

3.2.6 There are a number of elements to note in the definition:

Person	can mean an individual or a corporation
Directions or instructions	these are clearly more than mere suggestions but may include non-professional advice in certain circumstances
Accustomed to act	there must be a pattern to the directions or instructions and occasional directions will not make someone a shadow director. However, again, the point at which conduct becomes habitual will depend upon the facts of a particular case
Advice given...in a professional capacity	this was thought originally to have been inserted to protect those such as solicitors who may sit in on board meetings and/or advise the board of a company but clearly it applies to all advice of a professional nature

In practice, what conduct makes someone a shadow director?

3.2.7 After the 1986 Insolvency Act was passed, there was initial concern expressed by banks and others advising banks that banks, in particular, were at risk of being held to be shadow directors. However, various extra-judicial pronouncements, case law and official guidance from the Insolvency Service have established a number of guidelines in connection with the type of conduct that may make someone a shadow director. In respect of the actions banks are likely to engage in when a customer is in financial difficulty, it is unlikely that the following actions will lead to a bank being found to be a shadow director:

(a) sending an investigating team to review the company's current financial condition;
(b) requiring a reduction in existing overdraft facilities;

(c) require security or further security in respect of amounts outstanding;

(d) call for information, valuations of fixed assets, accounts, cash flow forecasts, etc;

(e) request the customer's proposals for the reduction of the overdraft, including the submission of a business plan, schedule of proposed sales, etc; and

(f) advise on the desirability of strengthening management, seeking fresh capital, etc.

3.2.8 In addition to the above points, the disqualification unit of The Insolvency Service has indicated that it will look at the following grounds to see if an individual has acted as a de facto or shadow director:

(a) whether the person was a signatory to the bank account;

(b) whether memoranda of interviews with bank officials point toward shadow directorship or de facto directorship;

(c) whether there is evidence of the person ordering goods or services;

(d) whether there is any written documentation which the person has signed as a director;

(e) whether he has been attending board meetings;

(f) whether there is evidence from creditors or employees that he has acted as such; and

(g) where the company has gone into liquidation, whether he is the only person able to give the insolvency practitioner (certain) information.

3.2.9 A recent review of the statutory definition of and the requirements for shadow directorship was provided by the Court of Appeal in *SSTI v Deverell* (2000). Lord Justice Morritt (delivering the unanimous decision of the Court), after reviewing the previous case law, set out a number of propositions concerning the statutory definition of a shadow director.

(a) The term "shadow director" should not be narrowly construed so as to limit Parliament's intention to protect the public from those involved in the management of a company which had become insolvent;

(b) The purpose of the Company Directors Disqualification Act 1986 legislation was to identify those, other than professional advisers, who had exercised "real influence in the corporate affairs of the company" and it was not

necessary that such influence should be exercised over the whole field of a company's corporate activities;

(c) Classifying a particular communication from a shadow director as a direction or instruction, whether by words or conduct, must be objectively ascertained by the court in the light of all available evidence. It is not necessary to prove that it was understood or expected, as between the giver and receiver of the relevant instruction or direction, that the instruction or direction would be followed. In many cases it will suffice simply to show that the instruction or direction was subsequently followed. Whether the parties label the communication as an "instruction" or "direction" will be no more than a factor that the court will take into account;

(d) Non-professional advice may fall within the statutory description of an "instruction" or "direction". The fact that the legislation expressly includes a proviso excluding advice provided in a professional capacity indicates that general non-professional advice may be included. The Court stated that "the concepts of "direction" and "instruction" do not exclude the concept of "advice" for all three share the common feature of "guidance". In summary, "frequent non-professional advice usually acted on is sufficient";

(e) There is no requirement for the properly appointed directors to whom directions or instructions are given to cast themselves in a subservient role or to specifically have surrendered their discretion. The Court concluded that such a requirement would be to add an unnecessary gloss to the statutory requirement that the board were "accustomed to act in accordance with" such directions or instructions;

(f) The use of epithets or descriptions in place of the actual statutory definition of a shadow director were not always helpful. For example, to describe the board of directors as the "cat's paw, puppet or dancer to the tune of the shadow director implies a degree of control both of quality and extent over the corporate field in excess of what the statutory definition requires"; and

(g) There is no requirement for a shadow director to "lurk in the shadows": it may occur but it is not an essential ingredient to the recognition of a shadow director. The Court provided the example of a person resident abroad who owns all the shares in a company but chooses to operate that company through a local board of directors situated in the place of incorporation of the company. If, from time to time, the shareholder, to the knowledge of all of those to whom it may be of concern, gives directions to the board of directors but takes no part in the actual management of the company himself, he may well be a shadow director even though he makes no attempt to hide the part he plays in directing the affairs of the company.

3.2.10 It is clear that in recent years the courts have sought to move away from a narrow legalistic approach to the requirements of shadow directorship. In each case regard must be had to the frequency of the advice or instructions (whether over the running of the business as a whole or merely in specific areas) and whether such advice was usually acted upon (whether or not the directors have expressly or impliedly surrendered their discretion) so that it may be

said that the third party in question exerted a "real influence over the affairs of the company".

3.2.11 Administrative receivers and administrators will not be shadow directors as they assume the functions of the directors but do not instruct the directors.

3.3 Officers

3.3.1 Liability for many of the acts identified in Question 2 above is often imposed on an "officer" of the company. As noted above[40], 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 744 of the Companies Act 1985 states that the term *includes* a director, manager[41] or secretary of a company. Others who may be officers of a company include auditors[42] and administrators. Receivers, including administrative receivers, will not be officers of a company[43].

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[44].

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 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.

3.4.3 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[45]. The legal rules relating to knowing assistance and/or receipt of property are applicable in

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[40] See explanation of definition of "officer" in footnote 12 to paragraph 2.3 above.

[41] The concept of a "manager" is not defined in either the Companies Act 1985 or the Insolvency Act 1986. It is not clear whether a person would need to have been appointed to a post carrying managerial responsibilities or whether it is sufficient that he has taken some part in the management of a company's business even at a junior level. In *Re a Company No.00996 of 1979* [1980] Ch 138 Shaw LJ stated: "[Any] person who in the affairs of the Company exercises a supervisory control which reflects the general policy of the Company for the time being or which is related to the general administration of the Company is in this sphere of management. He need not be a member of the board of directors. He need not be subject to specific instructions from the board." Consequently, the definition is potentially a wide one especially in relation to those provisions (such as section 212 IA 1986) which place liability on any person who has been "concerned in the … management of the Company".

[42] 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.

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

[44] Section 212 IA 1986; see paragraph 2.9 above.

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

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 (may incl. shadow directors)	Same as for director
Restriction on re-use of company name	Shadow director within 12 months of company's liquidation	Same as for director
Personal liability for contravention of restriction on re-use of company name	Any person involved in the management of the company	Same as for director

Offence/activity	Persons liable	Extent of liability
Transaction at undervalue	Recipient of property received	Return of property received and/or pay compensation to the company
Preference	Recipient of preference	Return of property received or removal of specific benefit received
Transaction defrauding creditors	Recipient of property	Return of property received
Dishonestly assisting or knowingly receiving property or assets in breach of duty	Any person with the requisite degree of "knowledge" who knowingly assists in a breach of duty owed by a person to a company or knowingly receives property from a breach of duty owed to the company	Where requisite knowledge and other applicable conditions are satisfied a person may be held to be a constructive trustee of the property and required to return such property or pay compensation equal to the loss caused.

QUESTION 4

4. Counterparties dealing with the company during the twilight period

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

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

4.1 Introduction

4.1.1 Most legal systems can be expected to have rules which seek to overturn transactions operating to the detriment of a company and/or are unfairly beneficial to a counterparty, which are entered into during the twilight period if a formal insolvency actually occurs.[46] This reflects the weakened state of a company

[46] 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

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[47]:

(a) which are at an undervalue;
(b) which are preferences;
(c) defrauding creditors;
(d) which constitute extortionate credit bargains;
(e) comprising floating charges given for past value;
(f) in breach of the directors' fiduciary duties;

or which involve the following elements:

(g) onerous property;
(h) dispositions of the company's property made after the commencement of winding-up;
(i) unregistered charges.

We look briefly at each head in turn.

4.3 Transactions at an undervalue[48]

4.3.1 By way of overview a transaction at an undervalue is a transaction entered into at a time when the company is insolvent and it later goes into administration or liquidation and is one where the company receives significantly less than it gives and there are no counterbalancing reasons why it benefits the company. The attack may be made by an administrator or liquidator and the court has a range of options if it finds there has been a transaction at an undervalue in order to restore the position.

Conditions for setting aside a transaction at undervalue

4.3.2 The court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied:

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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.

[47] Most of these heads of challenge do not apply in respect of market contracts or margin contracts effected by an exchange or clearing house - Companies Act 1989, s164.

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

(1) The company is in liquidation or administration and an application is made by the liquidator or administrator (s 238(1) and (2)).

(2) The company entered into a transaction at an undervalue either: within the two years ending with the "onset of insolvency", or between the time of presentation of a petition for an administration order and the making of the order on that petition (ss 238(2), 240(1)((a), (c)). The onset of insolvency is defined as the passing of a voluntary winding up resolution or the presentation of a winding up petition or administration petition (s 240(3)) and therefore is not a reference to the company's financial state.

(3) The company was unable to pay its debts within the meaning of s 123 IA 1986 (see answer to question 1 but, briefly, this means that it fails either the cashflow or the balance-sheet test of insolvency) either: at the time of entering into the transaction, or in consequence of entering into it (s 240(2)). Where the creditor is a person 'connected with' the company (see answer to question 1) there is a rebuttable presumption of the company's inability to pay its debts (s 240(2)).

What is a transaction at an undervalue?

4.3.3 A company enters into a transaction with a person at an undervalue if it:

(1) makes a gift to that person; or

(2) otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or

(3) enters into a transaction with that person for a consideration the value of which is significantly less than the value, in money or money's worth, of the consideration provided by the company (s 238(4)).

4.3.4 A transaction is defined as including a gift, agreement or arrangement, and references to entering into a transaction are to be construed accordingly (s 436). In one case (*Phillips v Brewin Dolphin* [1999] 2 All ER 844) the court held that "transaction" was to be widely construed but must be identified by reference to the person (or persons) with whom it was entered into by the company. The court therefore appeared to accept that as between the company and the counterparty or counterparties it will look beyond the form to the substance in ascertaining what constitutes the transaction. Thus two contracts between the company and the counterparty may, if sufficiently intertwined, be viewed as a whole.

4.3.5 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.

Defences

4.3.6 The court may not make an order under this provision if it is satisfied:

(1) that the company which entered into the transaction did so in good faith and for the purpose of carrying out its business; and

(2) that at the time it did so there were reasonable grounds for believing that the transaction would benefit the company (s 238(5)).

Further, the court may not make an order which would prejudice certain purchasers in good faith and for value. There are specific rules governing the meaning of good faith in the context of notice of the circumstances giving rise to the undervalue (s241(2) and (3)).

Examples of financial transaction that may fall within the section

4.3.7 In the leading case on this issue (*Re M C Bacon* [1990] BCC 78) the court held that the creation of security over a company's assets as security for a company's own liabilities could not be a transaction at an undervalue. The provision required, it was held, a comparison to be made between the value of the consideration obtained by the company and the value of the consideration provided by the company. Both values have to be measured in money or money's worth and have to be considered from the company's point of view. The mere creation of security over the company's assets does not deplete them or diminish their value. Loss by the company of the ability to apply the proceeds of the assets otherwise than in satisfaction of the secured debt is not capable of valuation in money terms, nor is the consideration received by the company in return.

4.3.8 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.

4.4 Preferences[49]

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

Conditions for setting aside a 'preference'

4.4.2 The court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied:

[49] Section 239 IA 1986.

(1) The company is in liquidation or administration and an application is made by the liquidator or administrator (s239 (1) and (2))

(2) The company gave the preference within a vulnerability period ending with the 'onset of insolvency' (s239(2))[50]. 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[51] (other than by reason of being its employee) the vulnerability period is two years; and (s240(1)(a));.

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

(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.[52]

What is a preference?

4.4.3 A company gives a preference to a person if:

(1) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities; and

(2) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done (s 239(4)).

Examples of preferences include the payment of a debt or giving of security to a particular creditor who would otherwise only have received partial payment on a winding-up.

4.4.4 In determining whether a creditor has been preferred the critical test is whether what is done would have the effect of disturbing the statutory order of priorities in an insolvent liquidation. The phrase "going into insolvent liquidation" is not expressly defined in this provision but is presumed to mean a liquidation where creditors are not paid in full.

Defences

4.4.5 The court shall not make an order under this provision in respect of a preference given to any person unless the company which gave the preference was influenced in deciding to give it by a desire to have the effect of giving a preference to that person (s 240(5)). This is a question of fact - board minutes prepared when the relevant transaction was taken will be a starting point in this respect.

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[50] This concept is the same as for transaction at undervalue - see paragraph 4.3.2(2) above.
[51] See answer to question 1 at paragraph 1.1.6 for an explanation of this concept.
[52] See paragraph 4.3.2(3) above

4.4.6 In *Re M C Bacon* 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 under this provision as the directors' desire was to obtain continued funding not to put the bank in a better position.

4.4.7 Where the beneficiary is connected with the company (otherwise than by reason of being its employee) that person, 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 4.3.6 above).

4.5 Transactions defrauding creditors[53]

Conditions

4.5.1 Where a transaction at an undervalue is entered into by a company for the purpose of putting assets beyond the reach of a person who is making or may at some time make a claim against the company or of otherwise prejudicing the interests of such person in relation to the claim he is making or may make, the court may make an order restoring and protecting the interests of the persons who are victims of the transaction.

4.5.2 It is not necessary that the company shall be in liquidation or administration, nor is there any statutory time limit. Essentially, this provision uses the same concept of 'undervalue' as for section 238 (discussed above) with the additional requirement that the company or person effecting the transaction does it for the purpose of putting assets beyond the reach of creditors but there is no requirement that the company be in an insolvency procedure.

Defences

4.5.3 There are protections for good faith purchasers for value without notice of the relevant circumstances (s425(2)).

[53] Section 432 IA 1986.

4.6 Extortionate credit transactions[54]

Conditions

4.6.1 The court may set aside or vary a transaction for, or involving, the provision of credit to the company where the following conditions are satisfied:

(1) the company is or has been a party to the transaction;

(2) the company is in liquidation or administration (s 244(1) applying s 238(1)) and the administrator or liquidator brings an action;

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

(4) the transaction was entered into within the three years prior to the day on which the administration order was made or (as the case may be) the company went into liquidation.[55]

4.6.2 A transaction is regarded as extortionate if, having regard to the risk accepted by the person providing the credit:

(1) the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit, or

(2) it otherwise grossly contravenes ordinary principles of fair dealing (s 244(3)).

The concept is one of a party taking improper advantage of an imbalance in bargainers power so as to produce a result that is oppressive.

4.6.3 There is a rebuttable presumption that a transaction with respect to which an application is made under this provision is extortionate (s 244(3)).

Defences

4.6.4 There are no statutory defences (other than successfully to disprove the allegation).

4.7 Avoidance of floating charges for past value[56]

4.7.1 This provision (s245), 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.

[54] Section 244 IA 1986.
[55] That is, a winding-up order is made or resolution of members passed for voluntary winding-up.
[56] Section 245 IA 1986.

Conditions for setting aside

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

(1) the company is in liquidation or administration; and

(2) the floating charge was created,

(a) in the case of a charge created in favour of a connected person within the period of two years ending with the onset of insolvency[57] (s 245(3)(a)); or

(b) in the case of a charge created in favour of any other person, within the period of 12 months ending with the "onset of insolvency" (s 245(3)(b)); or

(c) in the case of a charge created in favour of any person, between the presentation of a petition for an administration order and the making of an order on that petition (s 245(3)(c))

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

(4) in the case of a charge given to a person not connected with the company, the company was then unable to pay its debts within the meaning of s123[58] or became unable to do so in consequence of the charge (s 245(4)).

4.7.3 Under section 245(2), no new consideration is given and the charge will be invalid except to the extent of the aggregate of:

(1) the value of so much of the consideration for its creation as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge;

(2) the value of so much of the consideration as consists of the discharge or reduction, at the same time as, or after, the creation of the charge, of any debt of the company; and

(3) the amount of interest (if any) payable on those sums in pursuance of the agreement under which money was paid, the goods or services supplied, or the debt reduced or discharged.

4.7.4 The new consideration must be for the charge and it must go to the company itself or in the reduction of the company's indebtedness. Where goods or services are provided rather than new money it is the true value of the goods and services that counts not the value that the parties may ascribe to them (s 245(6)).

Defences

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

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

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[59] - and over time the whole balance in the account may be represented by these new withdrawals 'hardening' the security (i.e. rendering it invulnerable from attack under this head of challenge).

4.8 Breach by directors of general/common law duties

4.8.1 If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general common law duty to put the company's interests first. Where the counterparty has knowledge of this, there may be circumstances where there are proprietary or restitutionary rights to recover the property. These are rights under the general law and whilst not dependent upon insolvency as such, they are more likely to be examined and/or exercised after a formal insolvency event.[60]

4.9 Disclaimer of onerous property[61]

4.9.1 When the company is being wound up (in England and Wales only), the liquidator may, by giving the prescribed notice, disclaim any onerous property and may do so notwithstanding that he has taken possession of it, endeavoured to sell it, or otherwise exercised rights of ownership in respect of it.

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

4.9.3 An example of onerous property would be a lease under which the company was the tenant and where the rent was greater than a market rent. Where the counterparty has a proprietary as opposed to a personal interest in the property, there can be no disclaimer: for example, where the company is selling land, contracts have been exchanged and the buyer tenders the purchase price, the buyer is likely to be able to obtain specific performance of such a contract.

4.9.4 There can be no disclaimer of an executed contract (one which has been wholly performed by one party but not the other) as opposed to an executory contract (where neither party has wholly performed its obligations).

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[59] This is known as the rule in *Clayton's Case* (1816) 1 Mer 572.
[60] See generally discussion of directors duties in answer to question 2
[61] Section 178 IA 1986

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 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.

4.10 Dispositions of the company's property made after the commencement of winding-up[62]

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.

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[63]

4.11.1 English law operates a system of registration of security created over certain property by English companies and by overseas companies which have an established place of business in England. Failure to register within 21 days of creation renders the charge void against an administrator or liquidator or a creditor (in practice a secured creditor). Whilst it is the company's duty to register the charge under section 399(1) CA 1985, any party interested in the charge is able to and, indeed, is well advised to effect the application itself. Any fees properly paid in doing this can be recovered from the company.

4.11.2 Section 396 defines the charges which have to be registered:

(a) a charge for the purpose of securing any issue of debenture;

(b) a charge on uncalled share capital of the company;

(c) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale;

(d) a charge on land (wherever situated) or any interest in it, but not including a charge for any rent or other periodical sum issuing out of the land (the holding of debentures entitling the holder to a charge on land is not deemed to be an interest in land);

(e) a charge on book debts of the company (where a negotiable instrument has been given to secure the payment of any book debts of a company, the

[62] Section 127 IA 1986
[63] Section 395 Companies Act 1985

deposit of the instrument for the purpose of securing an advance to the company is not treated as a charge on those book debts);

(f) a floating charge on the company's undertaking or property;

(g) a charge on calls made but not paid;

(h) a charge on a ship or aircraft, or any share in a ship;

(i) a charge on goodwill, or on any intellectual property (i.e. any patent, trade mark, registered design, copyright or design right; or any licence under or in respect of any such right).

QUESTION 5

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5. Enforcement

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

5.1 Introduction

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

5.1.2. There are two main exceptions to this general rule. First, where criminal proceedings are brought against directors or others in respect of some form of criminal action, such proceedings must be brought by the Director of Public Prosecutions ("**DPP**") on behalf of the relevant government department or authority[64]. Secondly, only the Secretary of State ("**SST**"), or the Official Receiver (appointed where the company is being wound-up by the court) acting at his direction, may bring proceedings for disqualification under sections 6 ("unfitness" to be a director) and 8 (disqualification after investigation by the SST in a company's affairs) of the CDDA 1986.

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[64] Section 218 IA 1986.

5.2 Criminal Proceedings

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

Offences[65]

(a) Fraud in anticipation of winding-up - section 206
(b) Transactions in fraud of creditors - section 207
(c) Misconduct in course of winding-up - section 208
(d) Falsification of company's books - section 209
(e) Material omission from statement relating to company affairs - section 210
(f) False representations to creditors - section 211
(g) Restriction on re-use of company name - section 216
(h) Fraudulent trading - section 458 Companies Act 1985

5.3 Civil Proceedings

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

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

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

Activity/transaction	Person able to bring proceedings
Misfeasance	Liquidator, Official Receiver, a creditor or, with leave of the court, a contributory[66]
Fraudulent trading	Liquidator only[67]
Wrongful trading	Liquidator only
Personal liability for unlawful re-use of company name	DPP[68]
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"[69]
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

[66] 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. 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.

[67] An action brought under this provision is for a contribution towards the assets of the company. Criminal proceedings will be brought under section 458 Companies Act 1985.

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

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

QUESTION 6

6. Remedies: orders available to the domestic court

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

Offence	Remedy Available
Wrongful Trading	The director may be ordered to make such contribution to the company's assets as the court thinks fit. In exercising its discretion under this section the Court may include a punitive element in the order as well as a compensatory element. However jurisdiction under section 214 is primarily compensatory. Where the court makes a contribution declaration it may make further directions to give effect to it as set out below in connection with section 213 IA 1986. Where the Court makes a declaration under section 214 that an individual is liable to make contribution to a company's assets, then whether or not an application has been made for his disqualification, the court may make an order that he be disqualified from acting as a company director for a period of up to 15 years.
Fraudulent Trading[70]	If tried by a jury the penalty is up to seven years imprisonment and/or a fine and, on summary conviction, a term of imprisonment of up to six months and/or a fine up to the statutory maximum (currently £5,000).
Fraudulent Trading[71]	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. 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).

[70] Under Section 458 Companies Act 1985 - criminal liability.
[71] Under Section 213 IA 1986 - civil liability requiring a director to contribute to the assets of the company for loss caused.

Offence	Remedy Available
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 company documents including making an omission in a document[72]	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.

[72] Section 450 Companies Act 1985

Offence	Remedy Available
Fiduciary Duties	The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.
Duties of skill and care	The director may be ordered to compensate the company for all loss and damage caused by breach of his fiduciary duty.
Conduct rendering a director unfit to be a director[73]	The court may order disqualification for a period of between 2 and 15 years. There is no financial penalty.
Transactions at an undervalue and preferences	The court may make such order as it thinks fit in order to restore the position to that which would have existed if the company had not entered into the impugned transaction. It may, for example, order: (a) that any property transferred as part of the impugned transaction be re-vested in the company; (b) that any property which represents the application of either the proceeds of sale of the property or money wrongfully transferred be vested in the company; (c) the release or discharge of any security given by the company; (d) require any person to pay such sums as represent the value of any benefits received by him from the company in breach of sections 238 or 239 IA 1986; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or in part) under the transaction, or by giving of the preference, to be under such new or revived obligations to that person as the court thinks appropriate; (f) that security be provided for the discharge of any obligation imposed by or arising under the order; or (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.

[73] Section 6 CDDA 1986

Offence	Remedy Available
	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[74]	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.

[74] Section 423 IA 1986. The requirements for liability to arise under this provision are explained in question 5 above. Liability under section 423 is civil.

Offence	Remedy Available
Extortionate Credit Transactions[75]	The impugned transaction may be set aside or the court may make an order to vary the transaction on such terms as it sees fit. It may, for example, make an order: (a) setting aside the whole or part of any obligation created by the transaction; (b) varying the terms of the transaction or the terms on which any security for the purposes of the transaction is to be held; (c) requiring any person who is or was a party to the transaction to pay to the office-holder any sums paid to that person by virtue of the transaction, by the company; (d) requiring any person to surrender to the office-holder any property held by him as security for the purposes of the transaction; (e) directing accounts to be taken between any persons.
Avoidance of a floating charge[76]	The Court can declare that the floating charge is invalid in whole or in part.

QUESTION 7

7. Duty to co-operate

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

(b) Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations (e.g. in the UK and other European 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:

[75] Section 244 IA 1986. See explanation of the provisions of this section in the answer to question 5. Liability is civil.
[76] Section 245 IA 1986. See explanation of these provisions in answer to question 5. Liability is civil.

(a) an administration order is made in relation to the company; or
(b) an administrative receiver is appointed; or
(c) the company goes into liquidation; or
(d) a provisional liquidator is appointed[77]; or
(e) a winding-up order has been made by the court in England and Wales.

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'[78]. 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 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
(c) the date on which the provisional liquidator was appointed; or
(d) the date on which the company went into liquidation.

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.

[77] 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.
[78] The Official Receiver is a civil servant from The Insolvency Service, an agency operating under the aegis of the Department of Trade and Industry. He is often appointed liquidator on a winding-up order being made, although where there are assets in the liquidation a creditors meeting will be likely to appoint a private accountant liquidator.

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[79]

7.2.1 Section 234 IA 1986 applies in the case of a company where:

(a) an administration order is made in relation to the company; 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.[80]

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[81]

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.

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[79] Section 234 IA 1986
[80] That is the administrator, administrative receiver, liquidator or provisional liquidator.
[81] Section 236 IA 1986

Sanctions

7.3.3 If a person does not appear before the court when summoned, or if there are reasonable grounds to believe that a person is intending to avoid his appearance, the court may issue a warrant for the arrest of the person and the seizure of any relevant property. The courts' enforcement powers with respect to section 236 also include powers (under section 237) to:

(a) order any person who, as it appears to the court, on consideration of any evidence obtained under sections 236 or 237, has in his possession any property of the company, to deliver the whole or any part of the property to the officer-holder at such time, in such manner and on such terms as the court thinks fit; and

(b) order any person who, as it appears to the court, on consideration of any evidence so obtained, is indebted to the company, to pay to the office-holder, at such time and in such manner as the court may direct, the whole or any part of the amount due, whether in full discharge of the debt or otherwise, as the court thinks fit.

There are also powers to examine persons either in the UK or abroad.

7.4 Company's statement of affairs[82]

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[83]

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

[82] Section 131 IA 1986
[83] Section 133 IA 1986

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

7.5.2 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[84]

7.6.1 In a creditors' voluntary liquidation ("**CVL**")[85] 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[86]

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

[84] Rules 4.39 and 4.40, IR 1986
[85] 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.
[86] Section 208 IA 1986

6th Protocols (which are defined together as the "**Convention Rights**").

7.8.2 The directors and others identified in question 3 will have Convention Rights. This is the case whether they are individuals or companies. In an insolvency context, a director or other person with Convention Rights under the HRA will be able to:

(a) require that a particular provision of insolvency law is construed in accordance with those rights or otherwise declared incompatible; or

(b) claim that the insolvency practitioner is a public authority and is acting unlawfully in breach of that person's Convention Rights.

7.8.3 The application of the HRA will also have the following effects:-

(a) Legislation - Primary and subordinate legislation will be read in a way that is compatible with the Convention Rights. If this is not possible, the court may make a declaration of incompatibility. In the case of subordinate legislation (for example the Insolvency Rules 1986) the court may give relief against any incompatibility provided that this is not inconsistent with the primary legislation (for example the Insolvency Act 1986).

(b) Public authorities - It will be unlawful for public authorities to act in a way which is incompatible with a Convention Right. A victim may bring proceedings for judicial review or damages. "Public authority" is not defined under the HRA, but it includes persons whose functions are of a public nature. If the nature of the act is private, then the performer of the act is not a public authority. As officers of the court, the Official Receiver, administrators, compulsory liquidators, provisional liquidators and court appointed receivers are all "public authorities" when carrying out functions of a public nature. Voluntary liquidators and administrative receivers are not officers of the court but have public functions so are also likely to fall within the definition.

7.8.4 However, it should be recognised that the Convention Rights are not absolute and may well be limited by authorised interference by the state where such interference is (a) justified by a limited aim and/or (b) proportionate to the need in hand.

7.8.5 In the context of insolvency, and the duties of co-operation discussed above, certain Convention Rights may be particularly relevant. These include:

(a) Article 6 - the right to a fair trial;
(b) Article 4 - prohibition of slavery and forced labour
(c) Article 8 - right to respect for private and family life;
(d) Protocol 1, Article 1 - right to the peaceful enjoyment of possessions.

7.9 Article 6 – Right to a fair trial

7.9.1 Article 6(1) provides that:

"In the determination of his civil rights and obligations or of any criminal

charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly but the press and public may be excluded from all or part of the trial in the interests of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice."

These provisions apply in respect of both civil and criminal proceedings.

7.9.2 In criminal proceedings, the use of compelled statements makes those proceedings unfair.[87] The Attorney-General has issued guidelines that, in such proceedings, prosecutors should not generally make use of answers obtained under compulsory powers (notwithstanding provisions such as section 433 IA 1986 which make such answers admissible). In civil proceedings, however, the use of compelled evidence does not *per se* mean that a hearing is unfair.[88]

7.9.3 There is some debate whether directors' disqualification proceedings (under CDDA 1986) are criminal or civil in nature. The recent case-law suggests that such proceedings are regulatory and not criminal, although they are capable of being described as penal.[89] Thus the Court of Appeal has recently 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[90]. 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[91].

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[92].

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

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[87] *Saunders v UK* (1997) 23 EHRR 313 [1998] 1 BCLC 362; e*x parte McCormick* [1998] BCC 379.
[88] *Re Westminster Pty Management Ltd, Official Receiver v Stern* (Court of Appeal, 2nd February, 2000).
[89] 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.
[90] *Re Westminster Pty Management Ltd, Official Receiver v Stern* (ibid).
[91] *Slinn v UK*, 26th June, 1996.
[92] See *Fayed v UK* (1994) 18 EHRR 393.

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[93]. 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.[94]

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.

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[93] Cf *Haig v Aitken* [2000] 2 All ER 80, where, in the context of bankruptcy, the Article 8 right confirmed the judge's view that private correspondence was not to property within the bankrupt estate.

[94] A fortiori, in the context of bankruptcy, the compulsory psychiatric examination of a bankrupt was allowed where that was in the interests of creditors: *Meeder v Netherlands,* 9 EHRR 546 (1986).

7.13 Human Rights law in practice

7.13.1 It remains to be seen how the courts of England and Wales will integrate Human Rights law with the law of insolvency. However, the Court of Appeal has stated in strong terms that the courts should be robust in resisting spurious human rights arguments following the introduction of the HRA into the general law[95].

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 The general rule is that no limitation period applies to criminal proceedings unless stipulated by statute. No limitations 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 [96].

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[97]. 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 [98].

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 [99].

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[95] *Walker v Daniels* (Court of Appeal, Woolf MR, 3rd May, 2000).
[96] Section 9 of the Limitation Act, 1980
[97] Section 21(3) of the Limitation Act 1980
[98] Section 21(1) of the Limitation Act 1980. *Belmont Finance v Williams (No. 2)* [1980] 1 AER 393
[99] 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

8.1.5 The limitation period applying to disqualification applications pursued under section 6 of the CDDA 1986 is 2 years from the date on which the company went into either insolvent liquidation, administration or administrative receivership. The court does enjoy a discretion, however, to extend this period which may be exercised in circumstances where, for example, the director has contributed to the delay in bringing proceedings, the charges laid against the director are particularly serious and there is a public interest in ensuring that they are pursued and where it is still possible for the director to receive a fair trial.

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[100].

8.2.2 Appeal may take the form of an appeal from the decision of the court of first instance or from its refusal to review, rescind or vary its order. These appeals are based on an error made in the findings of fact or an error of law or a wrongful exercise of discretion. The appellate court will overturn an exercise of discretion by the court of first instance only if it is satisfied that no judge, properly instructed as to the law with regard to the relevant facts, could have reached the conclusion that was reached in the court below.

8.2.3 Hearings take place at first instance before either a County Court Judge, a Registrar of the High Court or a Judge of the High Court depending upon the complexity of the case and the value of the amount in issue. An appeal from the decision of the County Court Judge and the Registrar lies to the Judge of the High Court without leave. The leave of either the Judge of the High Court or of the Court of Appeal is required for an appeal from the decision of the Judge of the High Court sitting as a court of first instance to the Court of Appeal. If the Judge of the High Court is hearing the matter on appeal from the County Court or a Registrar of the High Court, leave from the Court of Appeal is required for a further appeal[101].

8.2.4 These provisions apply to both civil and criminal proceedings brought under the Court's insolvency jurisdiction. Leave to appeal is required where the proceedings are based on breach of the director's fiduciary or common law duties[102].

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were not known at the date on which it accrued. The extension allowed under this section is a further 3 year period from the date on which the claimant had both the knowledge required to bring the claim and the right to do so. This is subject to a long stop under section 14 of the 1980 Act which provides that no action shall be brought in respect of a negligence claim more than 15 years after the date on which the act of negligence relied upon occurred.

[100] Rule 7.47(1) of the IR 1986

[101] Practice Direction [2000] BCC 927

[102] CPR Part 52.3

QUESTION 9

9. Foreign Corporations

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

9.1 Introduction

9.1.1 As noted in question 5 above, subject to criminal proceedings, the ability to enforce the rights and duties of directors will usually be undertaken by an "office holder" appointed pursuant to either a winding-up order or an administration order. In particular, the tables set out in question 5 above specify who may bring actions against a director. Consequently, the ability to bring actions against directors of foreign companies will depend on the extent of the jurisdiction of the English courts to wind-up a foreign company or alternatively to place a foreign company in administration. For the purposes of the IA 1986, foreign companies and other corporations are classified as "unregistered" companies[103].

9.1.2 In general, all the provisions of the IA 1986 relating to the winding-up of a UK registered company will apply equally on the winding-up of an "unregistered" company[104].

9.2 Jurisdiction of English courts

9.2.1 The IA 1986 provides no specific criteria which will allow the English courts to wind-up a foreign company. Instead, the courts have developed a general test consisting of three "core" requirements. These can be summarised as follows:

(a) there must be a sufficient connection with England and Wales which may, but does not necessarily have to, consist of assets within the jurisdiction of the English court;

(b) there must be a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order; and

(c) one or more persons interested in the distribution of the assets of the company must be persons over whom the court can exercise jurisdiction.

9.2.2 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

[103] Section 220 IA 1986. An "unregistered company" will include an "association" formed for gain or profit.
[104] Section 221 IA 1986.

foreign company to claim statutory redundancy payments; that the debt upon which the winding-up petition is founded was incurred within the English jurisdiction; and where the liquidator would be entitled to launch a claim against the former directors of the foreign company for wrongful trading which may subsequently produce a realisation to be distributed to creditors. It will usually be fairly clear whether or not the making of a winding-up order will potentially benefit creditors of the foreign company if the potential return will be more than *de minimis*. Likewise, the court will need to be satisfied that those who may benefit are either subject to the jurisdiction or have submitted to the jurisdiction of the English court.

9.2.3 Under the provisions of the IA 1986 there is no specific power for the English court to make an administration order over a foreign company. However, as a result of other provisions contained in the IA 1986, the English court is under a duty to assist, as far as possible, a request for assistance in connection with particular proceedings which is received from a court in any other part of the United Kingdom or from any "relevant country or territory"[105]. In particular, where the English court receives a request from a relevant country or territory to make an administration order in respect of a foreign company, the relevant provisions of the IA 1986 specify that the English court to which such a request is made may apply, in relation to the issues specified in the request which it has received, either the insolvency law applicable in the jurisdiction of the court making the request (in relation to comparable matters falling within the English court's jurisdiction) or the normal insolvency law of the United Kingdom. This apparently wide authority is limited by the normal rules of private international law and consequently, the English court retains a discretion to refuse to provide assistance in certain circumstances (for example, where providing such assistance would prejudice local creditors).

9.2.4 However, where it is appropriate to respond to a request for the appointment of an administrator over a foreign company, the English court will have the power to make such an appointment and the administrator so appointed will enjoy the normal powers afforded to an administrator of an English company including the ability to review transactions and if necessary to apply to the court to have any transactions at undervalue or preferences set aside.

9.3 Specific powers of the English court relevant to foreign directors

9.3.1 As noted in paragraph 9.1.2 above, the general principal of English law is that following a winding-up order being made against a foreign company, all the provisions of the IA 1986 will apply in the same way as for an English company. Of the relevant provisions concerning the enforcement of directors' duties, the English courts have recently 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. This will be the case even if the country of incorporation of the relevant company does not contain

[105] Section 426 Insolvency Act 1986. At the present time, the list of relevant countries or territories are: Anguilla, Australia, The Bahamas, Bermuda, Botswana, Brunei, Canada, Cayman Islands, Gibraltar, Hong Kong, The Virgin Islands, Malaysia, South Africa, Wales, Scotland and Northern Ireland.

an equivalent provision within its insolvency laws. However, the English court would take account of the standard of care and other duties owed by those directors in the country of incorporation of the company when deciding whether to make those directors liable for their actions. The English courts have also held that in the winding-up of a foreign company the provisions of the IA 1986 relating to transactions at undervalue and preferences will apply. It should also be noted that the provisions of section 236 IA 1986 placing directors under an obligation to provide information will apply equally to directors domiciled abroad.

9.3.2 In addition, various provisions of the CDDA 1986 relating to the disqualification of a director may be applied by the English courts. This will be the case irrespective of whether the director was resident within the jurisdiction, whether the conduct of that director took place within the jurisdiction or whether or not the director is a British citizen. This will be important for directors of foreign companies as a disqualification order may be made on the basis of "unfitness" to be a director not only as a result of wrongful or fraudulent trading but also as a result of being a director of a company which has entered into a transaction at undervalue or given a preference. A director may also be found "unfit" to be a director as a result of a breach of the various other requirements imposed on directors under the Companies Act 1985 or the IA 1986 and which are detailed in the responses to questions 2 and 3 above.

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 It is permissible for a director to take out insurance against misfeasance claims and the company may lawfully pay the premiums[106]. The company may also lawfully indemnify any director in respect of the cost of defending any proceedings (whether criminal or civil) in which judgment was given in his favour [107].

10.2 The insurance policy cannot enable the director to insure against his own wilful or fraudulent wrongdoing as it will be struck down on grounds of public policy in this regard. However, it is felt that it is possible to insure against wrongful trading. It would not, however, be possible to insure against fraudulent trading given the public policy considerations.

10.3 The main insurance policy available to directors and recommended by the Institute of Directors is the director's personal liability cover. This specifically excludes any claims based on or arising out of any insolvency proceedings and

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[106] Section 310(3) Companies Act 1985
[107] Section 310(3)(b) Companies Act 1985

insolvency is defined in similar terms to that laid out in question 1.[108] A policy is, however, available by which directors can insure against actions arising out of insolvency, but such cover must be obtained from specialist brokers through Lloyds.

QUESTION 11

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

11.1 Overview

11.1.1 The details of directors' duties are considered above at question 2. Directors, when their company is insolvent or may become insolvent, must think of the interests of the creditors of their company rather than the shareholders - as it is the creditors' money that is now at risk. The interest of the equity holders has vanished. So, for example, while a transfer of assets at less than full market value may, when a company is solvent, be ratified by the shareholders (they can in a sense do what they like with their money - although note that they cannot make an illegal return of capital, see *Aveling Barford -v- Perion*) in the case of insolvency or potential insolvency the breach of duty inherent in the sale at less than market value cannot be ratified by the shareholders. This is the position at common law but is also reflected in the clawback provision under section 238 IA 1986 in connection with transactions at undervalue (see question 4 above). Similarly, generally speaking some creditors should not be paid ahead of others (the law of preferences - the successor to the Roman Paulian action).

11.1.2 Usually the most difficult decision for directors is whether to incur more credit. English law tackles this in two, not entirely, compatible ways. The main focus of attention as described at question 2 above, is the question of whether it can be said there is a 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

[108] Information obtained from Chubb Insurance Limited, the official insurers recommended by the Institute of Directors.

will be fraudulently trading even though doing his best for the general body of creditors.

11.1.3 English law therefore seeks to strike a balance between the need to stop directors running their companies at the expense of creditors and exploiting them and, on the other hand, not putting undue pressure on directors in what is a very difficult time. Directors need to be strong but not reckless. They need robust, helpful, legal advice but must be stopped from believing in "pie in the sky" schemes.

11.1.4 In practice, in England, well-advised directors will get independent professional help on the legal and accounting sides to bolster any decision they make to carry on trading. 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. Remarkably, English and U.S. law are quite different in their approach although this has not been greatly remarked upon. The American approach is to encourage the survival of the company by striking down transactions out of the ordinary course but allowing repayments in accordance with the practice of the business hitherto. In England, the focus is on what the directors are subjectively trying to do. If pressure is operating on the mind of the directors - pressure from creditors who threaten winding-up proceedings for example - then it is unlikely that the directors are going to be motivated by a 'desire' to put any particular creditor in a better position but are in fact likely to be simply trying to ensure their own survival. This encourages creditors to put pressure on a company in trouble, the opposite of the effect in the United States.

11.3.2 What is the practical reality for a creditor considering the preference law? The practical answer almost always will be: 'take the money/security'. It may well be hard to show what the subjective intention of the directors was and particularly to show that it was to benefit a particular bank or other creditor. Why should the director want to achieve that end? Where the director had given a personal guarantee to that creditor the answer may be all too obvious, but in the absence of those incriminating circumstances preference law in the U.K., certainly on the basis of the leading first instance decision of *Re M.C. Bacon,* has few teeth.

11.4 Transactions at an undervalue

11.4.1 The law quite properly wishes to prevent a company dissipating its assets at less than market value where that will reduce the dividend to creditors. But how can a counterparty wishing to buy assets from a company facing insolvency know that a liquidator or administrator will not try and set the transaction aside if an administration or liquidation does indeed ensue? Well, the answer is that he does not know. If the price is less than market value, then unless the transaction is for other reasons in the interests of or benefit to the company and for the purposes of its business carrying on, it is likely to be attacked. English law has not fully resolved what the court will do where it finds undervalue but common sense suggests that in most cases the counterparty will be expected to make up the difference in value.

11.4.2 Thus, in many cases a robust counterparty will 'do the deal' (i.e. complete the transaction) and fight any attack by a liquidator or administrator later. If they have got a very keen price which is insupportable then they have to expect they might have to disgorge the benefit. The difficulty probably arises where they buy a business in substantial need of investment and they are concerned that the court may in fact reverse the entire transaction. However, where someone has altered their position and further invested it seems hard to believe the court would seek to reverse the transaction when there is an alternative simply to require a cash payment to make up the undervalue. A practical answer is to seek comfort that the directors have taken proper professional - often accounting but perhaps also legal - advice on their position and confirmation that the directors are satisfied that the transaction is in the interests of the company. A solvency certificate would be useful if the company is not actually insolvent at the time or as a result of the transaction. In practice that is unlikely to be forthcoming. The temptation may well be to say that the deal can only be done with an insolvency practitioner and require the company to go into a formal insolvency procedure but again that can often damage the goodwill of the business or render key contracts or assets liable to termination and may harden the attitude of counterparties to such key contracts who might otherwise have been prepared to agree to a sale or assignment to a purchaser.

APPENDIX

Summary of primary English insolvency procedures

1. Introduction

1.1 When a corporate borrower faces insolvency there are a variety of insolvency options available, some of which are open to the company and some of which are only open to its secured creditors.

1.2 There are four principal insolvency regimes for English companies:

(a) receivership (including administrative receivership);

(b) voluntary arrangements and schemes of arrangement with creditors;

(c) administration; and

(d) liquidation (also known as winding-up).

1.3 Receivership may be classified as a self-help remedy for secured creditors. Voluntary arrangements involve compromises of the companies' debts with its creditors which can be statutory and formal **or** out of court arrangements. Administration and liquidation are the formal statutory procedures for dealing with companies which are insolvent, administration having been introduced by the IA 1986 as an additional method of dealing constructively with a company's difficulties.

2. Receivership

2.1 Although in certain circumstances, often arising out of litigation, the court may appoint a receiver for specific purposes, in English insolvency law when the term receiver is used it is almost always taken to mean the appointment of someone to enforce security given by a company to those to whom it has obligations - normally its bankers. If the holder of the security has the power to appoint a receiver or administrative receiver under the terms of the security and that power has arisen (for example on default by the borrower to make payment), then the charge holder may appoint a receiver or administrative receiver to take control of the assets and/or business of the borrower without the need for any authorisation of the court.

2.2 The IA 986 also introduced a special category of receiver called an administrative receiver (not to be confused with an administrator). Technically, an administrative receiver is someone appointed over all or substantially all the assets of a company under debentures secured by charges which include a floating charge. The significance of a receiver being an administrative receiver rather than an ordinary or non-administrative receiver is two-fold. First, there are certain powers and certain duties affecting specifically an administrative receiver under the legislation but, much more importantly, where an administrative receiver has been

appointed the court is not allowed to make an order for administration. (See paragraph 4 below)

2.3 An administrative receiver's functions are to realise the assets and property charged and to repay the charge holder the amounts due to it after deduction of his costs, expenses and remuneration and, in the case of floating charge assets, after having paid the preferential creditors (the categories of preferential debts are set out in schedule 6 IA 1986 and include certain tax, VAT and employee liabilities). An administrative receiver or non-administrative receiver (who has been provided with management powers) may continue to trade the company's business prior to a sale on a going concern basis.

3. Voluntary arrangements

3.1 Where a company is essentially profitable but its debt burden and interest burden is too great, it may be able to persuade its creditors to convert some of their debt into equity and to continue funding the company. This is a simple example of a restructuring which might be effected through a voluntary arrangement or a scheme of arrangement. Arrangements can be pursued through the formal procedures set out in the IA 1986 and the Companies Acts, but a restructuring can also be effected on a simple contractual basis and most rescue and support operations are conducted out of court in that way.

4. Administration

4.1 Administration is a court-based procedure intended to fill the gap where either there is no secured creditor able to appoint an administrative receiver or that secured creditor is unwilling to appoint such a receiver. It is loosely modelled on the American chapter 11 procedure. It is dangerous to take this analogy too far.

4.2 Application for an administration order is made by the company itself (through its directors) or by a creditor. The court will decide at a hearing whether the order should be made and it may only be made if the company is insolvent, or likely to become so, and the court believes that one of a number of purposes can be achieved in the administration. The purposes for which an administration order may be made are (i) the survival of the company and part of its business as a going concern, (ii) the making of a voluntary arrangement, (iii) the making of a scheme of arrangement and (iv), if nothing else, a more advantageous realisation of the assets than could be achieved in a liquidation.

4.3 The administrator, who is appointed by the court, effectively displaces the directors in running the company and the idea is that he should produce proposals which he must put to meetings of the creditors within three months of his appointment detailing how he proposes to fulfil the purpose(s) for which the administration order was made. If his proposals are approved he implements them and, if not approved, he returns to court for his discharge.

4.4 One important feature of administration from the point of view of a secured creditor is that from the date of the presentation of the petition (and this is continued when the order is made) there is a freeze on creditor action without the leave of the court. The prohibition covers distraint, the levying of execution and the taking of proceedings etc. but it also includes the enforcement of security. On

presentation of the petition to the court, the only enforcement of security which may take place is that a creditor entitled to appoint an administrative receiver may do so. As stated above, this has the effect of preventing the making of an administration order. No other enforcement of security may take place however, and if an administrative receiver is not appointed before the order has been made, no enforcement of security, including the appointment of an administrative receiver, may take place. Effectively the secured creditor has one chance to appoint his administrative receiver.

4.5 Further, the administrator may use assets subject to a floating charge as if they were not subject to that charge, save only that any proceeds representing the floating charge assets are themselves again subject to the floating charge. With the sanction of the court the administrator may sell fixed charge assets free of the fixed charge, subject only to accounting to the fixed charge holder for market value or, if greater, the sale proceeds actually received. The effect for a secured creditor is, therefore, a loss of control. Lenders to a property company (for example) might wish to take a long term view of the property market and simply refuse to release their security until paid out in full. An administrator who chooses to sell at a particular point will oblige the secured creditor merely to accept market value (or sale proceeds) at that chosen time of sale.

4.6 There is one set of circumstances in which the court may still make an administration order, notwithstanding the fact that an administrative receiver has been appointed by secured creditors. If the security under which the administrative receiver has been appointed is vulnerable, either as a preference or under section 245 IA 1986 or as a transaction at an undervalue the court may discharge the administrative receiver and make an administration order.

5. Liquidation

5.1 Liquidation (or winding-up) is the dissolution procedure for companies under English law. In that sense, it might be thought similar to Chapter 7 in the United States ('Bankruptcy' is a term applied only to individuals in England, never to companies).

5.2 Liquidation can be in one of two forms. First, it can be a voluntary liquidation which occurs where the shareholders of the company pass a resolution to place the company into liquidation and, where the company is insolvent, a meeting of creditors will be called to confirm the identity of the person to be appointed as liquidator of the company. This procedure will be known as a creditors' voluntary liquidation. Alternatively, the company or a creditor may present a petition to the court for a compulsory winding-up, and if the company is insolvent, a winding-up order will be made by the court in due course. Liquidation has long been the standard dissolution procedure for English companies and the recent insolvency legislation has changed few of the basic rules. There is no freeze on enforcement of security by creditors.

FRANCE

QUESTION 1

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

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

1.1 Overview

1.1.1 For the purposes of assessing the vulnerability of transactions to attack (as opposed to the possible personal liability of directors), the twilight period is in practice known in France as the "suspect period" (*la période suspecte*)[1]. The suspect period is, therefore, the period during which certain transactions entered into by a company are vulnerable to attack. Under French law this period is distinguished from the period during which transactions entered into by a company are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company.

1.1.2 The date on which the suspect period is deemed to begin is that on which the company first became unable to pay its debts as they fall due or, to use the French terminology, in a state of cessation of payments – a cash-flow test.

1.1.3 The determination of the date on which the company first became unable to pay its debts (and therefore on which the suspect (twilight) period commenced) is made in one of three ways (in each case by the court with jurisdiction over the insolvency proceedings):

(a) the court finds in its judgment opening the formal insolvency proceedings that the date is the same as the date of the opening of such proceedings itself. In such a case, there is no suspect or "twilight" period.

(b) the court finds, as a question of fact, that the date occurred prior to the date of its order to open formal insolvency proceedings

(c) subsequent to the order to open formal insolvency proceedings, the court, on its own motion or upon application by the court appointed administrator, the representative of the creditors, the court appointed liquidator or the Public Prosecutor, decides to revisit its original determination on the basis of new facts and modifies the date of *cessation de paiements*.

1.1.4 The suspect or twilight period ends on the date on which the tribunal orders the opening of formal insolvency proceedings.

[1] Articles L.621-7 and L.621-107 of the Commercial Code (formerly, Articles 9 and 107 of Law n° 85-88 of 25 January 1985 as amended by Law n° 94-475 of 10 June 1994 (the "**French Insolvency Law**") which has recently been codified into the Commercial Code)

1.1.5 Except in respect of transactions made for no consideration, the maximum duration of the suspect or twilight period is 18 months[2]. Such period is not calculated as a function of the nature of the act in question. The maximum period of 18 months applies notwithstanding that the actual date of *cessation de paiements* is determined to be earlier.

1.1.6 With respect to transactions made for no consideration, the suspect or twilight period may be extended for up to an additional period of 6 months prior to the date of *cessation de paiements*.

1.1.7 The duration of the period during which transactions entered into by the company are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company is not specifically determined by law. Each of the different types of transaction in question is considered in more detail in response to question 4. In certain circumstances, the risk of liability arises only after the date of *cessation de paiements*. In other circumstances, instead of questioning whether the company is in a state of *cessation de paiements*, French law considers whether there is a causal link between the reprehensible act and the commencement of insolvency proceedings in respect of the company. There is in the latter type of situation, therefore, no formal period during which transactions are vulnerable.

1.2 Summary

1.2.1 If a company is cash-flow insolvent and within a vulnerability period thereafter (maximum eighteen months or twenty-four months in the case of transactions without consideration) goes into formal insolvency proceedings, certain specifically defined transactions may or must be declared null and void.

1.2.2 On the other hand, directors and/or others involved in the management of the company may be personally liable for certain types of transaction either if such transaction is entered into during the "twilight" period or if there is a causal link between the opening of formal insolvency proceedings and the transaction in question.

QUESTION 2

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2. Actions potentially giving rise to liability for directors

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

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

(i) is any resulting liability against a director civil, criminal or both?
(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?

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[2] Article L.621-7 of the Commercial Code (formerly, Article 9 of the French Insolvency Law).

(iii) will liability attach to individual directors in proportion to their specific involvement?
(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?
(v) what defences, if any, will be available in relation to each offence?

2.1 General

French law does not approach the question of the possible liability of directors and/or others associated with the management of a company which becomes subject to formal insolvency proceedings on the basis of the type of acts in question. Rather French law starts from the point of view of the types of causes of action available against such persons for which certain conditions, in terms of the behaviour of the director and/or others associated with the management of the company, must be fulfilled. The responses to this question are therefore set forth on the basis of the different types of causes of action available, enumerating (not in all cases exhaustively, since this would be impossible, the types of behaviour concerned).

2.2 Action "*en comblement de l'insuffisance d'actif*" (to bridge the insufficiency in assets)

2.2.1 Personal liability will follow where an officer (in law or in fact) of the company has[3]:

(i) made a fault in the management of the company ("*faute de gestion*"). The notion of fault in the management of the company is not specifically defined by statute. Caselaw has refined the concept to cover errors in the management of the company, lack of care (negligence) or breaches of law, regulation or the by-laws of the company. Determination of whether a *faute de gestion* has occurred is a question of fact for the courts.

(ii) the liabilities of the company exceed the value of its assets – such difference to be assessed at the time the court judges the liability of the director or other associated with the management of the company

(iii) the *faute de gestion* must be found to have contributed (in the sense of caused) to the insolvent situation of the company. It is not, however, necessary that the *faute* be the exclusive cause.

2.2.2 If (i) to (iii) are satisfied:

(i) Liability is civil.

(ii) The person found liable will be required to pay damages to the company. It is up to the judge to decide, on the basis of the seriousness of the *faute*, whether the person in question should pay damages or not. I.e., even if (i) to (iii) of 2.1 are satisfied, the judge is not required to condemn the guilty person.

[3] Article L.624-3 of the Commercial Code (formerly, Article 180 of the French Insolvency Law).

(iii) It is up to the judge to decide the amount of damages that the person found liable must pay to the company. The maximum amount of damages is the amount by which the *faute de gestion* resulted in the company being unable to pay its debts.

(iv) There is no specific time limit prior to the commencement of formal insolvency proceedings during which the *faute de gestion* must have occurred. In practice, of course, the period of time is limited by the need for there to be a causal link between the *faute de gestion* and the insolvency of the company.

(v) Other than the general defences of an absence of *faute* or an absence of causal link or an absence of insufficiency of assets, there are no specific defences to the action.

2.3. Personal insolvency proceedings

2.3.1 A director or other person associated with the management of the company may be subject to personal insolvency proceedings in the following circumstances (such proceedings being distinct from those ordered against the company itself)[4]:

(i) prior to the commencement of formal insolvency proceedings against the company;

(ii) the individual undertook one or more of four different types of action in his or her personal interest, namely:

(a) used property of the company as his or her own property; this concept covers a wide range of different types of behaviour covering most typically excessive remuneration, withdrawals from the company's bank account for personal ends, performance of renovation or other works by the company for personal ends, payment of personal expenses, etc. etc.

(b) in the guise of the company covering his or her own acts, undertook commercial transactions for his or her personal interest; this typically applies to directors who abuse their majority position in the company and direct the company in their own personal interest.

(c) used the property or credit of the company in a manner contrary to the company's own interest for personal ends for the ends of another company in which the director or other person associated with the management of the company has a direct or indirect interest; this type of behaviour is in practice very similar to that covered by (a);

(d) abusively and for personal ends pursued a loss-making activity which would inevitably lead to the company falling into a situation of *cessation de paiements*; this concept covers, typically, directors who, using artificial financial methods, maintain a company afloat for the purpose of continuing to receive remuneration, to reduce the amount of a personal shareholder loan or to pay off company debts that he or she has guaranteed.

[4] Article L.624-5 of the Commercial Code (formerly, Article 182 of the French Insolvency Law).

(e) kept fictitious accounts or destroyed the company's accounting books and/or records or failed to keep the company's accounts contrary with law and regulation. This covers a failure, whether full or partial to maintain the company's accounts. This is completed by the following.

(f) kept accounts that are manifestly incomplete or irregular.

(g) misappropriated or concealed all or part of the assets of the company or fraudulently increased the liabilities of the company. This is the most serious type of behaviour by which the individual sought to organise the insolvency of the company or to keep the assets of the company to the detriment of the company's creditors.

(iii) Although the provisions of the law do not specifically so require, typically there must be a link (if not formally so found to be causative) between the wrongful act in question and the insolvency of the company.

2.3.2 If (i) and any of (ii) are satisfied:

(i) liability is civil.

(ii) & (iii) given the nature of the sanction, neither question is applicable.

(iv) There is no specific time limit prior to the commencement of formal insolvency proceedings during which the specific wrongful action must have occurred. In practice, of course, the period of time is limited by the "informal" requirement that there is a link between the act in question and the insolvency of the company.

(v) Other than the general defences of an absence of one or more of the specific requirements for the offence, there are no specific defences to the action.

2.4. Personal insolvency – prohibition on management

2.4.1 In addition to the possibility of the extension of the insolvency proceedings against the company to its directors or others associated with the management of the company in point 2.3 above, an individual director may be subject to personal insolvency proceedings in any of the following five cases during the course of formal insolvency proceedings against the company[5]:

(i) having carried out the function of a director of a company when forbidden to do so;

(ii) with the intention of avoiding or delaying the opening of formal insolvency proceedings, having made purchases with a view to resale at a higher price or used ruinous means to obtain funds;

[5] Article L.625-2 of the Commercial Code (formerly, Article 186 of the French Insolvency Law) for personal bankruptcy and Article L.625-8 of the Commercial Code (Article 192 of the French Insolvency Law) for the prohibition on management.

(iii) having entered into, for the account of a third party, without consideration, undertakings judged to be too significant or important at the time of signature given the situation of the company

(iv) having paid or caused to be paid, after the date of *cessation de paiements* one creditor in preference to others

(v) having failed, within a period of 15 days, to have filed a declaration with the court of the existence of being in a situation of *cessation de paiements*.

(vi) Although the provisions of the law do not specifically so require, typically there must be a link (if not formally so found to be causative) between the wrongful act in question and the insolvency of the company – apart from those cases where, by definition no link is necessary, e.g., in respect of (iv) and (v) above.

2.4.2 If any of (i) to (v) are satisfied:

(i) liability in both the cases of personal insolvency and prohibition on management is civil – albeit that they have certain characteristics of penal sanctions.

(ii) (a) The sanction of personal insolvency carries with it prohibition on managing, administrating and controlling a commercial enterprise or any form of company which has an economic activity. A certain number of professions are also prohibited (e.g., the judiciary, the legal profession, activity as a financial intermediary, insurance agent, etc.) as well as all public functions. A person in personal insolvency also loses his or her political rights.

(b) The sanction of prohibition on management is a diluted form of personal insolvency and enables the court to adapt the sanction to the particular situation of the individual. The most severe form of the sanction is the prohibition on managing, administrating and controlling a commercial enterprise or any form of company which has an economic activity.

(iii) The court has discretion over the duration of the personal insolvency albeit that the minimum period in any case is 5 years.

(iv) Except in respect of (iv) and (v) of 4.1 above, there is no specific time limit prior to the commencement of formal insolvency proceedings during which the specific wrongful action must have occurred. In practice, of course, the period of time is limited by the "informal" requirement that there is a link between the act in question and the insolvency of the company. In respect of (iv) and (v) of 4.1 above, by definition the wrongful act must have taken place after the date of *cessation de paiements* which, as is explained above, depends upon a finding of fact by the court which opens the formal insolvency proceedings. Such date cannot be more than 18 months prior to the date of the order opening formal insolvency proceedings.

(v) Other than the general defences of an absence of one or more of the specific requirements for the offence, there are no specific defences to the action. A person found liable to personal insolvency may have some or all of the

prohibitions lifted if he or she can show that he or she has made a sufficient contribution to the payment of the insolvent company's debts.

2.5. Penal Bankruptcy (*Banquerote*)

2.5.1 This criminal offence may be committed in any of the following circumstances, provided that formal insolvency proceedings have been commenced in respect of the company[6]:

(i) where the person ,with the intention of avoiding or delaying the opening of formal insolvency proceedings, has made purchases with a view to resale at a higher price or used ruinous means to obtain funds;

(ii) where a person has misappropriated or concealed all or part of the company's assets;

(iii) where a person has fraudulently increased the debts of the company;

(iv) where a person has kept fictitious accounts or caused accounting books and records to disappear or failed to keep accounts contrary to legal requirements.

(v) where a person has kept manifestly incomplete sets of accounts or kept accounts that do not comply with legal requirements.

2.5.2 If any of (i) to (v) are satisfied:

(i) Liability is criminal.

(ii) A person guilty of this offence is liable to imprisonment (maximum of 5 years) or a fine (maximum of FRF 500,000) or both.

In addition, the court can impose any of the following sanctions:

(a) deprivation of civil rights;

(b) prohibition for a minimum period of 5 years on having a public function or conducting a professional activity in the same field as that in which the offence was committed;

(c) exclusion from being permitted to bid for public tenders for a period of at least five years;

(d) prohibition for a minimum period of 5 years from issuing cheques other than those enabling the drawer to draw funds deposited with the drawee or certified cheques

(e) publication of the judgment.

[6] Article L.626-1 of the Commercial Code (formerly, Article 196 of the French Insolvency Law).

Further if there is a civil party to the criminal proceedings, the court may award damages to such civil party provided that 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 Civil Code)

(iii) The gravity of the offence will be reflected in the length of imprisonment or the extent of the fine that is ordered and in the nature and extent of any of the other sanctions that may be imposed. In exercising its punitive jurisdiction, the court is not seeking to compensate the company

The amount of damages that may be awarded will depend upon the extent of the loss caused by the offending act.

(iv) Except in the case of the offence of misappropriation or concealment of assets of the company (for which the acts in question must have been committed once the company is in a state of *cessation de paiements*), there is no specific time period prior to the commencement of formal insolvency proceedings that the reprehensible acts must have been committed.

(v) Absence of intent to defraud is a defence to a charge under 2.5.1(i) and (iii). Absence of a voluntary and positive act of disposal is a defence to a charge under 2.5.1(ii).

2.6. Fraudulent organisation of insolvency

2.6.1 The officers or associated persons are liable for this offence if[7]:

(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.

(iv) The offence can only be committed once a company is in a situation of *cessation de paiements*.

(v) Absence of intent to defraud is a defence.

[7] Article L.626-14 of the Commercial Code (formerly, Article 209 of the French Insolvency 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 f 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 French insolvency law provides expressly that the liability that may attach to a formally appointed director or manager of a company extends to "de facto" managers or directors – known in French as *dirigeants de fait*. The definition of de facto director is explained below.

3.1.2 In certain circumstances, third parties may be found liable to the 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 the consequences thereof may be liable for the damage that they have caused.

3.2 De facto directors (*dirigeants de fait*)

3.2.1 A de facto director, under French law, is a person (individual or corporate) who has some form of an express link with the company in question. Typically the person is either a member of the company (in the form of shareholder, partner, employee, etc.), is associated (such as married) with a formal director, or is in a business relationship with the company (e.g., as a supplier or customer).

3.2.2 In all cases, the de facto director exceeds the powers that have officially and formally been given to it with regard to the management of the company's affairs.

3.2.3 Whether a given person has become a de facto director or not is a question of fact. Among the factors that the courts frequently take into account are the existence of an employment agreement the company and the person and the nature of the technical functions granted to such person. The notion is characterised by involvement in the directional functions of the company by a person who is not an official director. There is no need to find that the person is treated as a director by the other directors. The key to the notion is the active involvement by the person in the determining management of the company.

3.3 Other third parties who may be held liable

3.3.1 Third parties who are involved with a company which enters into formal insolvency proceedings may be subject to tortious liability if all or part of the loss suffered by the insolvent company's creditors is caused by their wrongful action. The existence of a fault (tort), damage and a causal link between the two must be established by the plaintiff. Most typically this type of action is brought by the creditors of an insolvent company against the bankers of the company on the basis that it contributed to the insolvent situation of the company by its dealings therewith. The loss may either be general – suffered by all of the creditors – in which case the representative of the creditors must bring the action. Alternatively the loss may be specific to one creditor in which case the action must be brought by the injured creditor alone. The action is a civil action and sounds in the payment of damages (either to the company in the event of a general action or to the injured creditor in the event of an individual claim).

3.4 Actions for which liability may attach to persons not formally appointed as directors

Offence/activity	Persons liable	Extent of liability
Action *en comblement de passif*	All directors and de facto directors (whether remunerated or not)	Same as for director
Personal liquidation	All directors and de facto directors (whether remunerated or not)	Same as for director
Personal insolvency	All directors and de facto directors (whether remunerated or not)	Same as for director
Prohibition on management	All directors and de facto directors (whether remunerated or not)	Same as for director
Bankruptcy	All directors and de facto directors (whether remunerated or not)	Same as for director
Fraudulent organisation of Insolvency	All directors and de facto directors (whether remunerated or not)	Same as for director

QUESTION 4

4. Counterparties dealing with the company during the twilight period

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

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

4.1 Introduction

4.1.1 Like many other legal systems, out of a concern to protect creditors and the company itself, French law recognises the right to bring proceedings for the nullity of certain payments and transactions made during the *période suspecte* (which as explained above begins with the date on which the company finds itself in a situation of *cessation de paiements* and ends on the date of the order commencing formal insolvency proceedings). The basis of such concern is the fear that the company facing financial difficulties may, either on account 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, grants certain favours and enters into certain transactions which are to the detriment of the company and/or unfairly beneficial to a creditor or counter-party and thus detrimental to the overall body of creditors.

4.1.2 The actions in nullity[8] are intended to reconstitute the assets of the company by sanctioning either the fraud committed by the company or the breach of the general principle of equality between creditors. A third party contracting with the company can, thus, see the transactions that it enters into with the company during the suspect period annulled on the basis of the French insolvency law.

4.1.3 In addition to the statutory bases of the action in nullity, French civil law also recognises an action, known as the "*action paulienne*" (a right of action given by Article 1167 of the French Civil Code to the creditors of a debtor to challenge transactions or other acts undertaken by the debtor defrauding the creditors' rights). Such right of action is not linked to the suspect period and can be used for example in the event that the conditions for the statutory bases of action are not satisfied.

4.2 Summary of heads of challenge

4.2.1 The transaction or payment in question must have occurred during the suspect period (i.e., after the date of *cessation de paiements* and prior to the judgment opening formal insolvency proceedings) by the company and not by a third party.

[8] On the basis of Article L.621-107 of the Commercial Code (formerly, Article 107 of the French Insolvency Law).

It must fall within one of the seven heads of challenge enumerated in Article L.621-107 of the Commercial Code (formerly, Article 107 of the French Insolvency Law). It is not, however, necessary for an interested person bringing the action in nullity to show that the act, falling within one of the heads of challenge, has caused loss to the company. The heads of challenge fall into two different categories: (a) those which must be annulled by the court if the legal requirements are met; and (b) those which, if the legal requirements are met, may be annulled by the court.

4.2.2 The potential heads of challenge are the following:

(a) Transactions which are null and void:

(i) Transactions undertaken by the company without consideration;

(ii) Any commutative transaction in which the company's obligations exceed those of its counter-party;

(iii) Payment of debts which are not due;

(iv) Payments made in a manner not commonly admitted in business relationships;

(v) All deposits and consignments;

(vi) All guarantees granted for existing debts;

(vii)All conservatory measures made against the company or its assets.

(b) Transactions which may be annulled:

Any transaction, including payments for debts that have fallen due or transactions for consideration entered into during the suspect period if the counter-party knew that the company was in a situation of *cessation de paiements*.

Each head of challenge is considered briefly below.

4.3 Transactions for no consideration

The statutory text defines such transactions as "*les actes à titre gratuit translatifs de propriété mobilière ou immobilière*" (transaction for no consideration as a result of which real or personal property is transferred). The purpose of this text, covering all forms of gift, is to avoid transactions that plainly result in a reduction in the amount of the assets of the company.

4.4 Unequal Bilateral Transactions

4.4.1 The statutory text defines such transactions as "*tout contrat commutatif dans lequel les obligations du débiteur excèdent notablemenet celles de l'autre partie*" (any bilateral "commutative" transaction in which the debtor's obligations clearly exceed those of the counter-party). A contract is "commutative" if, at the time of signature, the nature of the advantage that each party obtains from the contract

can be clearly ascertained. It covers, for example, the sale of personal property, the sale of merchandise, the creation of a guarantee, the transfer of a trademark. Consequently, contracts which include an element of risk are not included in the definition.

4.4.2 The advantages drawn from the contract by each of the parties must be clearly unequal, to the detriment of the company. The difference (a) must be objectively ascertained and ascertainable (b) must, economically and mathematically, be clear and (c) there must be an element of subjectivity in the bad faith of the importance of the inequality between the two parties. Examples include the sale of horses at 2/7 of their true value; the sale of merchandise at less than two thirds of their value.

4.5 Payment of debts which have not fallen due

The statutory text defines this head of challenge as "*tout paiement, quel qu'en ait été le mode, pour dettes non échues au jour du paiement*" (any payment, regardless of the manner in which it is effected, of debts which are not due at the date of payment). The reasoning behind this head of challenge is clear given the clear advantage given the creditor in question, it being of course unusual business practice to pay debts before they fall due.

4.6 Payments not normally recognised in business relations

4.6.1 The statutory text provides: "*tout paiement pour dettes échues, fait autrement qu'en espèces, effets de commerce, virements, bordereaux de cession visés par la loi n° 81-1 du 2 janvier 1981 facilitant le crédit aux entreprises, ou tout autre mode de paiement communément admis dans les relations d'affaires*" (any payment for debts that have fallen due made in manner other than in cash, bills of exchange (and the like), wire transfer, global transfer of credits in accordance with Law 81-1 of 2 January 1981 facilitating credit to enterprises, or any other method of payment commonly recognised in business relations).

4.6.2 The purpose is to avoid payments that, on account of the unusual nature, grant an advantage to one creditor over the mass. The notion of payments commonly recognised in business relations covers any method of payment which professionally is generally and habitually used in the appropriate field of business affairs.

4.7 Deposits and consignments

4.7.1 The statutory text provides: "*tout dépôt et toute consignation de sommes effectués en application de l'article 2075-1 du Code Civil, à défaut d'une décision de justice ayant acquis force de chose jugée*" (any deposit or consignment of monies effected pursuant to Article 2075-1 of the Civil Code unless made pursuant to a final and binding court ruling). Article 2075-1 of the Civil Code relates to any deposit of consignment of sums of money, bills of exchange and the like, or securities which an entity has been ordered to make as a guarantee or as a conservatory measure.

4.7.2 The purpose behind the challenge to all such types of transaction is on account of the priority right that such deposit or consignment grants to the creditor in question over and above the mass in accordance with Article 2073 of the Civil Code.

4.8 Creation of guarantees for existing debts.

4.8.1 The statutory text provides: "*toute hypothèque conventionnelle, toute hypothèque judiciaire, ainsi que l'hypothèque légale des époux et tout droit de nantissement constitués sur les biens du débiteur pour dettes antérieuresment contractées*" (any mortgage whether contractual, judicially ordered or pursuant to law as between spouses, and any pledge over property of the debtor granted for debts which have been incurred previously). The text covers, therefore, all forms of security over property whether real or personal. The key is the date on which the security is granted as compared to the date on which the debt in question was incurred by the company. If the latter is prior to the former, the action for nullity must succeed.

4.8.2 Again the reasoning behind the existence of this head of challenge is clear given the absence of any justifiable rationale to grant security over a debt that already exists, such security not having been a sine qua non for the creation of the obligation. Thus, the purpose of granting an advantage to the creditor in question through the giving of additional or new security is presumed.

4.9 Conservatory measures

4.9.1 The statutory text provides: "*toute mesure conservatoire, à moins que l'inscription ou l'acte de saisie ne soit antérieur à la date de cessation de paiements*" (any conservatory measure provided that the filing or the act of seisure was not prior to the date of cessation of payments).

4.9.2 The purpose is of this form of the action in nullity is to protect the company against conservatory measures obtained by a creditor against the company which would have the effect of giving such creditor an advantage over the mass. The reasoning behind this head of challenge is similar to that underlying the nullity of security granted for existing debts.

4.10 Nullity when the counter-party was aware that the company was in a state of *cessation de paiements*

4.10.1 Contrary to the other forms of the action in nullity, this head of challenge is discretionary for the judge. The statutory text[9] provides: "*les paiements pour dettes échues effectués après la date de cessation de paiements et les actes à titre onéreux accomplis après cette même date peuvent être annulés si ceux qui ont traité avec le débiteur ont eu connaissance de la cessation des paiements*" (payments for debts that have fallen due after the date of *cessation de paiements* and transactions for consideration entered into after that same date may be annulled if the person dealing with the debtor was aware of the *cessation de paiements*).

[9] Article L.621-108 of the Commercial Code (formerly, Article 108 of the French Insolvency Law).

4.10.2 Consequently, the transaction or payment in question must have taken place during the suspect period. There is no need to show that the company has suffered a loss as a result of the transaction. The purpose of the head of challenge is to reconstitute the assets of the company in an attempt to assist recovery. The key element to this head of challenge is the counter-party's knowledge that it was dealing with a company which was in a state of *cessation de paiements*. It is not enough that the counter-party knew that the company was in financial difficulties. It must be shown that it knew that the company was unable to meet its debts as and when they fall due. A fraudulent intent is thus necessary.

4.10.3 Given that this head of challenge is discretionary for the judge, the tendency is for the courts to take into account the seriousness of the bad faith and fraudulent intent of the creditor.

4.11 Action Paulienne

In addition to the specific actions provided for by the Commercial Code (incorporating the former French Insolvency Law of 1985), Article 1167 of the Civil Code provides a general right to any creditor to challenge transactions made defrauding its rights. This right of action is available regardless of the existence in the company in question of a state of *cessation de paiements*. A fraudulent intent must be shown to have existed on the part of the counter-party to the transaction with the company – such fraudulent intent aiming 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, it can request that the transaction be annulled.

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 The persons who may bring proceedings, whether civil or criminal, against the directors or associated persons are defined in the statutory texts.

5.1.2 In essence, with respect to the sanctions of *comblement de passif*, personal liquidation, personal insolvency and prohibition on management proceedings can only be brought by the liquidator, administrator or creditor's representative appointed by the court in the course of the formal insolvency proceedings, by the public prosecutor or by the court on its own motion.

5.1.3 The criminal actions of bankruptcy (*banquerote*) and organisation of insolvency may only be brought by the public prosecutor or, by initiating a civil action at the

same time, the liquidator, administrator or the creditor's representative, or, if a given creditor can show an individual specific loss, by such creditor also bringing civil proceedings at the same time.

QUESTION 6

6. Remedies: orders available to the domestic court

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

Offence	Remedy available
Comblement de passif	Liability is civil The director or associated person may be ordered to compensate for all or part of the insufficiency in assets resulting from his fault in management.
Personal liquidation	Liability is civil. The director or associated person will be subject to insolvency proceedings. The nature and result of such insolvency proceedings may be different from that ordered against the company.
Personal insolvency	Liability is civil The director or associated person will be prohibited from managing, administrating and controlling any commercial enterprise and any form of company which carries on an economic activity. He or she shall also be prevented from conducting certain professions such as the judiciary, legal profession, financial intermediary, insurance agent. He or shall shal be deprived of his or her civil and political rights.
Prohibition on management	Liability is civil. The director or associated person will be prohibited from managing, administrating and controlling any commercial enterprise and any form of company which carries on an economic activity. The court may limit such prohibition to certain sectors of activity.

Bankruptcy	Liability is criminal. The maximum penalty is five years imprisonment and a fine of FRF 500,000. In addition the director or associated person may be sanctioned by any of the following orders: - deprivation of civil rights; - prohibition for a minimum period of 5 years on having a public function or conducting a professional activity in the same field as that in which the offence was committed; - exclusion from participating in public tender offers for a period of at least 5 years; - prohibition for a period of at least five years on issuing certain forms of cheque; - publication of the judgment. If civil proceedings are associated with the criminal proceedings, the director or associated person in question may be ordered to compensate for any loss that his offending conduct has caused.
Fraudulent organisation of insolvency	The same as for bankruptcy.
Actions in nullity	Liability is civil. The payment or transaction which is annulled is thus rendered null and void. The asset transferred pursuant to the annulled transaction or payment must be returned to the company.

QUESTION 7

7. Duty to co-operate

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

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

7.1 Obligation to commence insolvency proceedings

7.1.1 French law imposes a duty on the legal representative of a company (i.e., the President of the Board of Directors in a traditional *société anonyme*, the President of the management board (*directoire*) of a two-tier managed *société anonyme*, the manager (*gérant*) of a *société à responsabilité limitée*) which is in a state of *cessation de paiements* first to hold a meeting of the workers' representatives (e.g., the workers' council where such exists or the personnel delegates where a workers' council does not exist) and to inform them of the situation and thereafter, within 15 days of the state of *cessation de paiements* occurring, to file a declaration of *cessation de paiements* at the registry of the commercial court where the company is registered.

7.1.2 Given that the other members of the management, such as the directors or the members of the management board, are liable along with the legal representative if the declaration of *cessation de paiements* is not made within such 15 day period (thus being exposed to the sanctions of personal insolvency or prohibition to manage) albeit that such persons do not themselves have the authority to file such a declaration, typically the filing of the declaration of *cessation de paiements* is made by the legal representative in close co-operation with the other members of the management of the company in question.

7.1.3 The declaration should contain:

(i) the last available annual financial accounts of the company;
(ii) an excerpt of the registration of the company;
(iii) a recent (no more than three months old) statement of the cash flow position of the company;
(iv) the number of employees of the company;
(v) the company's net turnover for the last financial year;
(vi) a statement of the amounts due and owing to and by the company and the names and addresses of the creditors and debtors;
(vii) a statement of the guarantees granted to and by the company and all off-balance sheet liabilities;
(viii) a summary statement of the assets of the company;
(ix) when judicial liquidation is requested, all elements necessary to demonstrate that the company has ceased activity or that the re-establishment of the company is impossible;
(x) the names and addresses of the representatives of the workers' council (where on exists) and the employee delegates (where no workers' council exists) empowered to represent the personnel of the company.

7.1.4 It should be noted that insolvency proceedings may also be commenced in a number of different ways by persons other than the legal representative of the company (for instance by one or more creditors of the company, by the public prosecutor or by the courts by their own motion).

7.2 Participation in the initial steps of the proceedings

7.2.1 Prior to determining whether a company is in a state of *cessation de paiements* and after having been seized by a request to such end, whether in the form of a request by the legal representative for a declaration of *cessation de paiements*, a

writ of action by a creditor, an originating summons by the public prosecutor or by the court by its own motion, the court must carry out a preliminary investigation. As part of such preliminary investigation, the court must summons the legal representative of the company in question to be heard. The participation of the legal representative in the initial investigation is of course of utmost importance given the knowledge and understanding of the difficulties faced by the company that such person would normally have.

7.2.2 In addition to summoning the legal representative of the company in question, the court must also convoke the representatives of the personnel (i.e., workers' council representatives or if no workers council exists the personnel delegates) as well any other person who can provide the court with information as to the actual situation in which the company is placed.

7.3 Right to be heard during the proceedings

7.3.1 Throughout the insolvency proceedings, the legal representative of the company in question has numerous specific rights to intervene either before the administrator, the *juge commissaire* or the court.

7.3.2 Examples include Article L.621-56 of the Commercial Code (formerly, Article 20 of the French Insolvency Law) which provides that the legal representative of the company must be consulted by the administrator, once the latter has been appointed by the court, to inform him or her as to the situation and prospects for the successful reorganisation of the company, the ways in which the company's debts can be paid off and the social conditions in which the company's activities could be pursued. Again, Article L.621-62 of the Commercial Code (formerly, Article 61 of the French Insolvency Law) provides that the court must summon the legal representative of the company when, following the expiry of the observation period, it rules on the future of the company – either judicial liquidation or one or more forms of reorganisation (continuation or transfer).

7.4 Obligation to collaborate during the proceedings

7.4.1. Given that the legal representative of the company in question is often the person best placed to know and understand the company and its activity, his or her collaboration with the judicial organs/officers instituted to conduct the insolvency or reorganisation proceedings is invaluable. French law thus provides for the close involvement of the legal representative of the company in all stages of the proceedings.

7.4.2 Article L.621-54 of the Commercial Code (formerly, Article 18 of the French Insolvency Law) provides that, under the general regime, the administrator appointed by the court must draw up a report setting forth the economic and social situation of the company. Such statutory text specifically provides that the legal representative must collaborate with the administrator in this process. The report must identify the origin, significance and nature of the difficulties affecting the company. The administrator is also to propose in such report either a programme for the reorganisation of the company or the judicial liquidation thereof. In companies subject to the simple regime where no administrator is appointed, the report is drawn up by the legal representative him or herself.

7.4.3 Article 69 of the Decree of 27 December 1985 provides that within eight days of the judgment opening the insolvency proceedings, the legal representative of the company in question must, if such list is not attached to the declaration of *cessation de paiements*, prepare and deliver to the creditors' representative or, if the judicial liquidation of the company is immediately ordered, the liquidator, a list setting forth the names and addresses of the creditors of the company, the amounts due and owing at the date of the commencement of the insolvency proceedings, the amounts coming due and at what date, the nature of the debts and any guarantees or charges relating thereto. The creditors' representative or the liquidator must then file the list with the court. Failure, in bad faith, to provide such list within such 8 day period exposes the legal representative of the company to the penalty of prohibition to manage, administer or control a legal entity (Article L.625-5 of the Commercial Code).

7.4.4 The legal representative of the company (and the other members of the management organ) retains the power to call meetings of the shareholders thereof whenever a shareholders' meeting is required in the course of the insolvency proceedings (for example when the reorganisation programme involves a modification of the share capital of the company) (Article L.621-58 of the Commercial Code, formerly, Article 22 of the French Insolvency Law). In the event of a failure by the legal representative to call any such shareholders' meeting, the administrator has the power to do so.

7.4.5 At the request of the administrator, the legal representative of the company must perform all steps and acts necessary to preserve the company's rights against its debtors and to preserve the production capabilities of the company (Article L.621-16 of the Commercial Code, formerly, Article 26 of the French Insolvency Law).

7.5 Rights granted to the legal representative

7.5.1 The legal representative of the company in question has the right (*locus standi*) to request the *juge commissaire* to seize the court with a view to replacing the administrator or expert(s) appointed by the tribunal (Article L.621-10 of the Commercial Code, formerly, Article 12 of the French Insolvency Law).

7.5.2 At any time during the proceedings, the legal representative has the right (*locus standi*) to file a request with the court for the total or partial cessation of the company's activities or the judicial liquidation of the company (Article L. 621-27 of the Commercial Code, formerly, Article 36 of the French Insolvency Law).

7.5.3 The legal representative has the power on behalf of the company to challenge any decisions taken by the judicial organs during the procedure that by law are open to challenge (for example against the decision of the *juge commissaire* to admit, reject or contest debts of the company declared by the creditors thereof in the course of the insolvency proceedings (Article L.621-105 of the Commercial Code, formerly, Article 102 of the French Insolvency Law)).

7.5.4 The legal representative has the right (*locus standi*) to request that the court extend the observation period (Article L.621-6 of the Commercial Code, formerly Article 8 of the French Insolvency Law) or the application of the general regime to a company initially placed under the simple regime (Article L.621-134 of the Commercial Code, formerly Article 138 of the French Insolvency Law).

7.5.5 Throughout the observation period following the commencement of the insolvency proceedings, the legal representative has a right to be informed by the administrator of the progress of his mission.

7.5.6 The creditors' representative must seek the legal representative's observations on the proposals to admit or reject or contest before the competent court the debts owed by the company and duly declared by the creditors thereof (Article L.621-103 of the Commercial Code, formerly, Article 100 of the French Insolvency Law).

7.5.7 The court must summon the legal representative of the company before it takes any decision with respect to the extension of the observation period (Article 20 of the Decree of 27 December 1985), the modification of the mission granted to the administrator (Article 54 of the Decree of 27 December 1985), to order the judicial liquidation of the company following the commencement of an observation period (Article L.621-27 of the Commercial Code, formerly, Article 36 of the French Insolvency Law), or to order a plan of reorganisation (Article L.621-62, formerly Article 61 of the French Insolvency Law).

7.5.8 It should be noted that the rights granted to the legal representative are broader under the simple regime as opposed to the general regime given that in the former a number of the rights and obligations granted to the administrator are vested in the legal representative. Thus, for example, it is the legal representative of the company in question which must draw up the draft re-establishment plan to be submitted to the court at the end of the observation period (Article L.621-139 of the Commercial Code (formerly, Article 143 of the French Insolvency Law).

7.6 Rights retained by the legal representative

7.6.1 In the event that the court orders the immediate judicial liquidation of the company at the commencement of the proceedings, the legal representative of the company is immediately stripped of all rights of action, power and authority with respect to the activity of the company. All such rights of action, powers and authorities are vested in the judicially appointed liquidator.

7.6.2 In all other cases, the legal representative remains at the head of the company with varying degrees of power and authority over the conduct of the activities of the company depending upon the nature of the mission granted to the judicially appointed administrator in the general regime or subject to the involvement of the *juge commissaire* in the simple regime.

7.6.3 The principal powers retained by the legal representative are twofold – namely, the power to take conservatory measures and the power to undertake acts in the ordinary course of business.

(i) The power to take conservatory measures. Conservatory measures in this context means those measures necessary to protect the rights of the company and to preserve the production capabilities of the company. Measures to protect the rights of the company include acts to stop statutes of limitation from running, the giving of formal letters before action (*mises en demeure*) to debtors of the company, and the creation or renewal of guarantees, charges and the like. Measures to preserve the company's production capabilities include the renewal of the company's stocks,

replacement of used or worn material, repair of damaged machinery and acts to prevent the theft or other wrongful disappearance of the assets of the company.

(ii) The power to undertake acts in the ordinary course of business of the company. Article L.621-23 of the Commercial Code (formerly Article 32 of the French Insolvency Law) provides that "acts taken in the ordinary course of business alone by the legal representative are deemed valid vis-à-vis third parties acting in good faith". Acts in the ordinary course of business in the sense of Article L.621-23 of the Commercial Code are those which fall within the scope of the normal business activity of the company, which are of such a nature as to be reproduced on a regular and frequent basis, which do not have a significant financial impact on the company and which would not be likely to be detrimental to the reorganisation of the company. Examples include 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 in amounts habitual for the company, and the sale of goods typically sold by the company on normal terms and conditions. The third party must be in good faith which means that it must not be aware of any restrictions on the legal representative of the company from undertaking the act in question. It is not however typically necessary for the third party to have undertaken any specific investigation into the powers and restrictions actually affecting the legal representative to prove its good faith.

7.6.4 The extent and nature of the other powers of the legal representative with respect to the activities of the company in question depend upon the nature of the mission granted to the administrator. It should be noted that the description of the mission granted to the administrator by the court when it opens an observation period with respect to any given company is noted on the register of the company and filed with the court clerk of the competent commercial court. The mission granted to the administrator falls within three broad categories in accordance with Article L.621-22 of the Commercial Code (formerly, Article 31 of the French Insolvency Law) – namely, supervision, assistance or representation.

(i) A mission of supervision. This is the situation where the legal representative of the company in question retains the widest powers over the management of the company. The legal representative must simply ensure that he or she does not commit any acts that are specifically forbidden by the Law (see below) and does not encroach upon the powers which, by definition, are vested in the administrator. Apart from the foregoing caveats, the legal representative of the company retains the power to act alone during the observation period with respect to the management of the company. His actions are simply subject to an ex-post facto control by the administrator.

(ii) A mission of assistance. A mission of assistance results in a situation of co-management of the company by the legal representative and the administrator, subject always to the caveat that those acts specifically forbidden by the Law cannot be undertaken (see para. 7.7 below). In practice, this type of mission means that the acts undertaken by the legal representative (other than those which the legal representative can always undertake (see para. 7.6.3 above)) are systematically verified and approved by the administrator before they are made. Thus the administrator will be

involved in all decisions to enter into new contracts, to order significant amounts of material or merchandise, to issue letters of credit, etc. The court may alleviate the burden of this type of involvement of the administrator in the management of the company by limiting the need for assistance and thus co-management to specific types of acts – generally those considered to be the most important or significant for the company.

(iii) A mission of representation. A mission of representation granted to an administrator is the most severe from the point of view of the legal representative of the company in question who, apart from those acts which he or she can always undertake (see para. 7.6.3 above), is to all intents and purposes stripped of his or her power to manage the company, such power being vested in the administrator during the observation period.

7.7 Acts that the legal representative cannot undertake

7.7.1 The acts that the legal representative cannot undertake fall into three broad categories: those which are forbidden as a general rule; those which are forbidden under the general regime and those that are forbidden in the simple regime.

7.7.2 Those acts which are forbidden to be undertaken by the legal representative as a general matter are the following.

(i) The legal representative cannot reimburse debts which existed prior to the commencement of the insolvency proceedings, any such reimbursement being at the risk of being annulled (Article L.621-24 of the Commercial Code (formerly, Art. 33 of the French Insolvency Law)). Except for a very limited number of exceptions specifically provided for by the Law, the reimbursement of any such debts must be approved beforehand by the *juge commissaire*.

(ii) The legal representative cannot undertake any acts that fall outside the ordinary course of business of the company in question (Article L.621-24 of the Commercial Code (formerly, Art. 33 of the French Insolvency Law)). This prohibition is of course the analogue to the right of the legal representative to undertake acts that fall within the ordinary course of business of the company noted above. If such an act, such as the sale of assets (as opposed to stock) of the company or the entering into of a settlement of a dispute, becomes necessary, it must be approved beforehand by the *juge commissaire*.

(iii) The legal representative is prohibited from granting any form of security over the assets of the company without the prior approval of the *juge commissaire*.

7.7.3 Under the general regime, in addition to the general prohibitions described above, there are the following restrictions on the acts that the legal representative can undertake:

(i) The legal representative cannot take any decisions with respect to the continuation or cessation of existing contracts binding the company to its customers or suppliers, the right of decision being vested in the administrator.

(ii) The legal representative cannot take any decision with respect to the making of personnel redundant for economic reasons. Again such right of decision is vested in the administrator.

(iii) The administrator alone has the authority to permit the payment of the price for goods purchased prior to the commencement of the insolvency proceedings but subject to a reservation of property clause. The special treatment of this type of situation which amounts to the payment of a pre-existing debt and thus is in general prohibited by the French Insolvency Law lies in the fact that without the payment of the totality of the purchase price the seller could exercise its rights under the reservation of property clause and thus obtain the possession of the goods in question thus endangering the chances of success of the insolvency proceedings.

7.7.4 The following is a recapitulative table of paragraph 7.7.3:

Prohibited acts	- Payment of pre-existing debts
Acts requiring prior approval of the *juge commissaire*	- Sale of operating assets - Grant of security - Redundancies - Settlements
Administrator's powers	- Continuation/termination of existing contracts - Payments under agreements subject to a reservation of property clause
Shared powers	Mission of supervision: - Ex-post facto verification by the administrator Mission of assistance - Co-management Mission of Representation - Management vested in the administrator
Unrestricted acts	- Conservatory measures - Acts in the ordinary course of business

7.7.5 Under the simple regime, when an administrator is not appointed, the powers of the legal representative are limited by the *juge commissaire* in the following manner.

(i) The legal representative must obtain the approval of the *juge commissaire* before continuing to perform a contract that binds the company to its customers or suppliers. Two situations can arise. Either the legal representative of the company indicates to the *juge commissaire* spontaneously his or her wish to continue performing an agreement after the commencement of the insolvency proceedings. Indeed, the legal representative must do so rapidly since unless expressly continued, all contracts binding upon the company prior to the commencement of the proceedings are automatically terminated one month after the opening of the proceedings. Alternatively, if the legal representative decides not to continue a given agreement, he or she may simply cease to perform the agreement without the intervention of the *juge commissaire*. One month after the commencement of the proceedings, the agreement would be terminated without the co-contractor having the right to require performance thereof by the company.

(ii) Redundancies of the personnel of the company for economic reasons cannot occur without the prior approval of the *juge commissaire*. Any such redundancy must fulfil three conditions, namely they must be urgent, inevitable and indispensable (Article L.621-37 of the Commercial Code (formerly, Article 45 of the French Insolvency Law).

(iii) Payment of the price for goods purchased subject to a reservation of property clause in favour of the seller requires the prior approval of the *juge de commissaire* for the same reasons as noted above (see para. 7.7.3(iii)).

7.7.6 The following is a recapitulative table of paragraph 7.7.5:

Prohibited acts	- Payment of pre-existing debts
Acts requiring the prior approval of the *juge commissaire*	- Sale of operating assets - Grant of security - Continuation of contracts - Redundancies - Payment of price under agreements subject to a reservation of property clause - Settlements
Unrestricted acts	- Conservatory measures - Acts in the ordinary course of business - Termination of agreements

7.8 Human Rights

7.8.1 France is a contracting party to the European Convention for the Protection of Human Rights and Fundamental Freedoms (Treaty of Rome, 4 November 1950) (the "**Convention**") the provisions of which are incorporated into French law.

7.8.2 The persons identified in response to question 3 will 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 legal representative, director or other person with Convention Rights under the Convention will be able to:

(i) require that a particular provision of insolvency law is construed in accordance with those Rights or otherwise declared incompatible; or

(ii) claim that the judicial organs are each a public authority and is 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 the a limited aim and/or proportionate to the need in hand.

7.8.4 In the context of insolvency, and the duties of co-operation discussed above, certain Convention Rights may be particularly relevant. These include:

(i) Article 6 – the right to a fair trial;
(ii) Article 4 – prohibition of slavery and forced labour;
(iii) Article 8 – right to respect for private and family life;
(iv) Protocol 1, Article 1 – right to the peaceful enjoyment of possessions.

7.8.5 Caselaw on the application of the Convention to insolvency proceedings is however particularly scarce in France.

QUESTION 8

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8. Appeals and limitation periods

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

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

8.1 Limitation periods

Limitation Period for Criminal Proceedings

8.1.1 Bankruptcy and fraudulent organisation of insolvency fall within the category of offences known as *délits correctionnels* and therefore the applicable limitation period is three years. Article L.626-16 of the Commercial Code (formerly, Article 211 of the French Insolvency Law) stipulates that the limitation period only runs from the date on which the commencement of formal insolvency proceedings is ordered.

Limitation Period for Civil Proceedings

8.1.2 Actions for *comblement de passif* are statute barred three years after the date on which the court orders the plan of reorganisationwithin the context of the formal insolvency proceedings or, failing such an order, the date on which the court orders the judicial liquidation of the company.

8.1.3 Actions for personal liquidation are similarly statute barred three years after the date on which the court orders the plan of reorganisation within the context of the formal insolvency proceedings or, failing such an order, the date on which the court orders the judicial liquidation of the company.

8.1.4 There is no specific limitation period for actions for the personal bankruptcy or prohibition to manage provided for in the French Insolvency Law. Given that these actions relate to personal sanctions it is considered by a number of commentators that instead of the general 10 year limitation period which is applicable to commercial actions, the thirty year limitation period applicable to personal actions should apply. The fact that there is no case-law on the issue demonstrates that this is a highly theoretical issue.

8.2 Appeals

Appeal in Criminal Proceedings

8.2.1 Appeal from a decision at first instance (before the "*correctionnel"* court) in respect of *délits correctionnels* is to the Court of Appeal of the district in which the court at first instance was sitting. Where the director is present at the hearing at which the judgment is rendered at first instance, the delay for appeal is 10 days from the date of the judgment. Alternatively the 10 day period runs from the date on which the judgment is served on the director.

Appeal in Civil Proceedings

8.2.2 Appeal is the Court of Appeal of the district in which the first instance court was sitting. Appeal is of right and is a re-hearing of the case at first instance. The appeal must be filed within one month of the date on which the judgment at first instance is served on the director.

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 Jurisdiction of the French courts

9.1.1 Article L.620-1 of the Commercial Code (formerly, Article 1 of the French Insolvency Law) provides as follows: "*le tribunal territorialement compétent pour connaître de la procédure de redressement ou de liquidation judiciaire est celui dans le ressort duquel le débiteur a le siège de son entreprise ou, à défaut de siège en territoire français, le centre principal de ses intérêts en France*" (the tribunal with jurisdiction over insolvency proceedings is that in the district in which the debtor has its registered office, or failing a registered office on French territory, the main centre of its interests in France).

9.1.2 The notion of "registered office" is construed as the actual decision making and administrative centre of the company and not the literal meaning of the term, namely, the office registered as such at the Trade and Companies Registry[10].

9.1.3 In the event of a request made before the French courts to commence insolvency proceedings against a foreign entity with a number of establishments in France, the French court with jurisdiction is that in the locality where the principal centre of the company's interests are based in France. This is a pure question of fact to be determined by the court.

9.1.4 The commencement of insolvency proceedings abroad in respect of a given company will not prevent the commencement of insolvency proceedings against the same company in France unless the foreign judgment must automatically be recognised in France under a bi- or multi-lateral treaty with the other state in question or if the foreign judgment has already been recognised and received an order of *exequatur*[11] from a French court.

9.1.5 All creditors, regardless of their nationality, would be entitled to prove their debts before the French court in the insolvency proceedings.

9.1.6 Further, once jurisdiction has been assumed by the French courts, all causes of action arising under French insolvency law will be available, regardless of where the assets or persons in question are situated. The only difficulty would be that of the enforceability of the orders of the French courts. Theoretically, therefore a foreign director could be liable for *comblement de passif* and transactions undertaken during the suspect period (i.e., after the date of the *cessation de paiements*) would be either treated by the French courts as being null and void (if falling within the provisions of Article L.621-107 of the Commercial Code) or at risk of being annulled if the circumstances fulfil the conditions of Article L.621-108 of the Commercial Code (see question 4 above).

[10] See Amiens, 15 December 1989, GP 1990 som. 315; Cass. Civ. 27 July 1987, Rev. Soc. 1988.97.
[11] See Cass. Com. 1995, RJDA 1995/10 n° 1146.

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 under French law for a company to take out insurance and to the premiums therefor in respect of the civil liability that its directors may incur in the course of the performance of their duties as such. Typically insurance policies of this type cover the directors' civil liability resulting from faults, errors, omissions, mistakes and false interpretations of legal or regulatory texts. Such an insurance policy can cover civil claims arising out of insolvency proceedings. It is however becoming more common for these types of insurance policies to exclude claims for *comblement de passif*.

10.2 As a general matter, it is not permissible for any person to insure against penal liability regardless of the nature of the sanction. Hence insurance cannot be obtained against bankruptcy, for example. Similarly, the insurance policy will typically exclude any form of fraudulent behaviour, even if the liability in respect thereof is civil in nature.

10.3 Given that the directors covered by the insurance policy must be identified therein, in practice the civil liability of a de facto director cannot be insured.

QUESTION 11

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

11.1 Overview

11.1.1 The details of the duties of directors and de facto directors are considered above in the response to question 2. As noted in such answer, French law does not focus on certain types of transaction but rather sanctions directors and persons in similar de facto positions for particular types of conduct. In other words, if a director incurs further credit during the twilight period, the risk of such director being exposed to liability lies in the circumstances in which and the reasons for which such further credit was incurred, rather than in the type of transaction through which such credit is obtained.

11.1.2 Consequently, if by incurring the further credit, the director for instance commits an act of mismanagement (e.g., there was no good reason for the company to incur such credit) or did so for his or her own personal ends and not for the company, he or she would be exposed to an action "*en comblement de l'insuffiance d'actif*" or personal bankruptcy, respectively.

11.1.3 A director must therefore be sure of the reasons for entering into any new transaction once the company in question is in a situation where, from a cash-flow point of view, the assets of the company are or risk to be insufficient to cover its due and owing debts.

11.1.4 Given the technical nature of the definition of "*cessation de paiements*" and that the date on which the court subsequently seized of the insolvency proceedings determines that the company in fact fell in a state of *cessation de paiements* may be fixed retroactively (up to 18 months before the commencement of the formal insolvency proceedings), it is possible for a manager to be running the company in a state of *cessation de paiements* without actually knowing that this is the case. Directors should therefore be particularly careful of their intentions when entering into new transactions whenever the company is facing financial difficulties.

11.1.5 In practice, in France, well-advised managers will get independent professional help, whether from insolvency practitioners, legal professionals, accountants and/or from the courts in voluntary reorganisation proceedings to assist them in any difficult decisions they may make to avoid insolvency. They will also often seek the support of their creditors and in particular their banks and major suppliers.

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

11.2.1 Articles L.621-107 and L.621-108 of the Commercial Code (formerly Articles 107 and 108 of the French Insolvency Law) provide for a series of different types of act which are either obligatorily or at the discretion of the court null and void if undertaken during the "twilight" or, in French terminology, "suspect" period – a period which, as noted above, can extend to 18 months prior to the date of the commencement of formal insolvency proceedings or 24 months in the case of transactions undertaken for no consideration.

11.2.2 The types of transaction which are automatically null and void if entered into during the twilight period are described in the response to question 4 above. It is thus clear under French law that a party transacting with a company that is or is likely to be in a situation of *cessation de paiements* must avoid each of the seven different types of transaction listed in Article L.621-107 of the Commercial Code. Failure to do so will result in the automatic nullity of the transaction and the concomitant measures of restitution required against the third party. It should be noted that the causation of a loss to the company is not a condition for the applicability of Article L.621-107 of the Commercial Code, neither is the bad faith or any form of wilful intent or knowledge that the company is in a state of *cessation de paiements* on the part of the third party.

11.2.3 Again as noted above in response to question 4, the courts have a discretion to avoid any transaction if it were 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 de paiements*. The apparently draconian nature of this power held by the courts is tempered by the need to show that the counter-party was aware not only that the company was in financial difficulties but that it was in the technical and special position of having an amount of available assets less than the amount of its due and payable debts.

APPENDIX

SUMMARY OF FRENCH INSOLVENCY PROCEDURES

1. Introduction

1.1 When a company faces insolvency there are a variety of insolvency options available under French law.

1.2 Prior to formal insolvency proceedings being commenced with the filing by the legal representative of the company of the declaration of *cessation de paiements* (or the commencement of such proceedings by a third party creditor, the public prosecutor or the court of its own motion), there are a number of ways in which, with or without the assistance of the court, a company can attempt to recover from its situation of financial difficulty. In addition to the various private aids and agreements that can be entered into whether with shareholders, creditors or employees, these possibilities fall into the following principal categories:

(i) Public assistance/aid;

(ii) Voluntary reorganisation (*règlement amiable*);

(iii) Appointment of a *mandataire ad hoc*;

(iv) Appointment of an *administrateur provisoire*.

1.3 Thereafter, if any of the foregoing actions fails to prevent the company from falling into a situation of *cessation de paiements*, the formal insolvency proceedings will follow one of two different regimes – the simple regime or the general regime, chosen largely as a factor of the size of the company in question. The two major differences between the two regimes is the appointment of an administrator in the general regime where typically no such judicial officer is named in the simple regime and the duration of the proceedings which is shorter in the simple regime.

1.4 Unless the judicial liquidation of the company is immediately declared, the initial phase of the proceedings will consist of an observation period during which the judicially appointed organs and officers, the legal representative of the company and the creditors will seek to determine the best alternative for the company (reorganisation or liquidation) followed by a ruling by the court on the type of reorganisation programme or liquidation that should be followed. There are two different types of reorganisation programme which can be combined:

(i) Continuation;

(ii) Transfer.

2. Public assistance

2.1 Public assistance may be either direct in the form of loans or subsidies or indirect in the form of extensions of delays for payment or tax relief. Such assistance is most typically granted by the administrative organs of the state albeit that other

local or regional public organisations are also involved in supporting and assisting companies in difficulty.

2.2 Restructuring Committees have been established by the central government whose role is to assist industrial companies which find themselves in financial difficulty by offering financial support to help bear the burden of measures of restructuring or reorganising which must be set forth in a clear and defined programme designed to save the company. These Restructuring Committees therefore offer a form of direct assistance.

2.3 The Commission des Chefs de Services Financiers et des Responsables d'Organismes de Sécurité Sociale ("The Commission of the Heads of Financial Services and the Managers of Social Security Organisms") has the authority, upon motivated request either by the company itself or by one of the Restructuring Committees, to grant delays for the payment of tax and social security debts. The Commission includes the Directeur des Impôts, the Director of the Banque de France, the Director of Social Security and the Director of the URSSAF.

3. Voluntary Reorganisation (*règlement amiable*)

3.1 The process of voluntary reorganisation applies to companies which are not in a state of *cessation de paiements* but which face financial difficulties. It is based upon the appointment of a conciliator by the competent commercial court and is aimed at the conclusion of an agreement between the company and the mass of its creditors with a view to restructuring the company's financial situation.

3.2 The procedure is initiated by the legal representative of the company filing a request with the competent commercial court, setting forth the financial, economic and social situation of the company, its financing needs and its means of meeting them.

3.3 The court has considerable investigative powers including the possibility to obtain bank and financial information so as to obtain a complete and accurate picture of the situation in which the company in question has found itself. The court can also appoint an expert to assist it in this information gathering task with a view to the drawing up of a report. It should be noted that the whole procedure is covered by the obligations of professional secrecy. Thus, any expert's report is available to the company but not to its creditors.

3.4 If the court considers that the situation of the company and the proposals made by the directors of the company so permit, the court will formally open the process of *règlement amiable* and appoint a conciliator for a period not exceeding three months which period may be extended by a maximum of one additional month at the request of the conciliator. The court will address to the conciliator the information that it has obtained, including any expert's report, during its initial inquiry.

3.5 The conciliator may request that all judicial actions between the company and its creditors be suspended if he or she considers that this will facilitate the process of concluding an agreement between the two. The duration of any such suspension ordered by the commercial court cannot exceed the duration of the mission of the

conciliator. The decision to suspend proceedings automatically carries with it an order on the company not to pay all or part of any debt pre-existing the decision of suspension (other than the salaries of its employees) and not to undertake any acts that are outside the ordinary course of business, including the grant of any new security.

3.6 As noted above the purpose of the process of the *règlement amiable* is to facilitate with the assistance of the conciliator the conclusion of an agreement between the company and its creditors to enable the company to meet its debts and improve its financial situation. If an agreement is reached it is approved formally by the court and filed at the companies registry. It should be noted that the agreement may be reached with the company's principal creditors alone (i.e., not with the whole mass of creditors), in which event the commercial court may grant extensions of payments in respect of other creditors, including the fiscal authorities. For the duration of the agreement, the company's creditors are prohibited from pursuing any form of judicial action against the company aimed at obtaining the payment of their debts.

3.7 Failure by the company to comply with the agreement reached with the creditors results in such agreement becoming null and void and all payments covered thereby becoming immediately due and payable. In such a situation it is frequent for formal insolvency proceedings to be commenced either by the court of its own motion or upon application by a creditor.

4. Appointment of a *mandataire ad hoc*

4.1 The appointment by the competent commercial court of a *mandataire ad hoc* over a company is designed to deal with a specific situation in which the company in question finds itself as opposed to a general problem of financial or economic difficulty.

4.2 The *mandataire ad hoc* is appointed by the competent commercial court upon application by the legal representative of the company. The appointment is made in the discretion of the court which defines the specific mission to be carried out by the *mandataire*. The legal representative of the company retains all of his or her prerogatives notwithstanding the appointment of the *mandataire*, in particular with respect to the management of the company.

4.3 Typically a *mandataire ad hoc* would be appointed in a situation where the company needs to negotiate for example extensions of payment with one or two specific third parties and not the whole mass of creditors. The duration of the functions of the *mandataire ad hoc* is not limited by law and thus occasionally, given the very short duration of the mission that can be granted to a conciliator in the *règlement amiable* procedure, a *mandataire ad hoc* may be chosen by the commercial court instead of the *règlement amiable* where a longer duration of mandate is thought to be necessary and the mass of creditors in question is not too large.

4.4 Any agreement entered into by the company following the intervention of the *mandataire ad hoc* is not, unlike under the *règlement amiable*, approved by the court and operates like any other agreement. It does not therefore, unless provided for in its terms and conditions, automatically result in the suspension of

judicial proceedings and cannot be unilaterally extended to persons who are not parties thereto.

5. Appointment of an *administrateur provisoire*

5.1 The appointment of an *administrateur provisoire* is appropriate for situations where a company is left to all intents and purposes without its management. This can arise for a variety of reasons including the existence of a deadlock among the managers or shareholders of the company in question. The role of the *administrateur provisoire* is therefore to assume conduct of the full management of the company. The *administrateur provisoire* represents the company vis-à-vis third parties. He or she can represent the company before the courts, operates the bank accounts of the company, draws up all financial statements and has the power to call shareholders' meetings.

5.2 Albeit that the appointment of an *administrateur provisoire* is not necessarily linked to the existence of financial difficulties affecting a given company, this procedure is by its nature in fact frequently associated therewith. For instance, the *administrateur provisoire* also has the power to file a declaration de *cessation de paiements* if the company finds itself in a situation of *cessation de paiements*.

5.3 At the end of his mission, the *administrateur provisoire* must file with the court a report of his actions.

6. Formal insolvency proceedings

6.1 Formal insolvency proceedings must be commenced by the filing by the legal representative of the company in question of a declaration of *cessation de paiements* (colloquially referred to as the *dépôt du bilan*) within 15 days following the date on which the company falls into a state of *cessation de paiements*. The sanctions to which the legal representative may be exposed if he or she fails to respect such delay are set out above in response to question 4.

6.2 Formal insolvency proceedings may also be commenced by the issue of a writ of summons by a creditor, by a request filed by the public prosecutor or by the competent commercial court of its own motion.

6.3 The competent commercial court (being that where the company in question is registered) first embarks on a preliminary investigation as to whether and if so when the company fell into a state of *cessation de paiements* and into whether the company has ceased activity or is incapable of being reorganised.

6.4 If the court comes to the decision that the company has either ceased activity or is incapable of being reorganised it will immediately issue an order for the judicial liquidation of the company. The purpose of the proceedings thereafter is not to redress the company but rather to obtain the most profit from the sale of the assets of the company to pay off the company's debts. The management of the company is immediately stripped of all authority which is vested in the court appointed liquidator. It is the liquidator with the assistance of the court that proceeds with the sale of the assets of the company and pays off the company's creditors.

6.5 In the event that the court determines following its preliminary inquiry that the judicial liquidation of the company is not necessary, it opens the observation period and appoints the various judicial officers who will conduct the investigation into the most appropriate manner in which to reorganise the company.

6.6 There are two possible regimes under which the reorganisation procedure may be conducted: the simple regime and the general regime. The simple regime applies to all companies which satisfy the two following criteria: at the date of the filing of the request for the commencement of the insolvency proceedings, the company employs no more than 50 employees and had a turnover in the last completed financial year of 12 months of less than FRF 20 million (Euro 3.1 million).
It should be noted that the court has the power at any time to apply the general regime notwithstanding that any given company satisfies the criteria for the simple regime depending upon, *inter alia*, the complexity of the problems affecting the company.

6.7 The judicial officers appointed by the court to conduct the proceedings are the following:

(i) a *juge commissaire* who is appointed at the very opening of the proceedings to oversee the progress of the procedure and to accelerate it if necessary. The role of the *juge commissaire* is more significant in the simple regime given the usual absence of an administrator.

(ii) a *mandataire de justice*, known as the creditors' representative in a process of reorganisation or the "*mandataire à la liquidation des entreprises*" in a process of judicial liquidation whose role is to verify the debts of the company, to represent the creditors of the company in any judicial actions and to verify the assets of the company in the event of a judicial liquidation.

(iii) an *administrateur judiciaire*, or administrator, which is typically only appointed in the event that a company is subject to the general regime. His or her role is to carry out the mission (of either supervision, assistance or representation) granted thereto by the court.

(iv) the *contrôleurs* who are appointed by the *juge commissaire* from among those of the company's creditors who so request to oversee the various operations of verification made by the other court appointed officers.

(v) the *représentant des salariés* who is not appointed by the court but by the employees of the company upon the request of the court and whose role is to verify the amount of wages overdue and unpaid as part of the list of debts of the company.

(vi) the *représentants du personnel* who in fact are the company law representatives of the employees (either the workers' council or the personnel delegates) who are to be consulted by the tribunal on the principal decisions to be taken throughout the proceedings.

6.8 The observation period lasts for six months in the general regime renewable once for an additional six month period by the court. In the simple regime the observation period is of four months renewable once for an additional period of four months.

6.9 During the observation period, the company continues to function with its management being supervised, assisted or represented by the administrator in the case of the general regime or under the control of the *juge commissaire* in the case of the simple regime.

6.10 It should be noted that at any time during the observation period, the court can order the transfer of all or part of the activity of the company or its judicial liquidation.

6.11 During the observation period the administrator (in the general regime) or the legal representative of the company (in the simple regime) must draw up a statement of the financial situation of the company together which his or her proposal for the reorganisation (or judicial liquidation) of the company.

6.12 If the court so orders, the reorganisation of the company can take one of two forms, or a combination of them both: namely, the continuation of the activity of the company, or the transfer thereof (in all or part).

6.13 The continuation of the company's activity (which may be combined with, for example, the cessation or transfer of one or more specific branches of its activities) must be on the basis of the clear intention and desire of the company to such end.

6.14 The transfer of all of part of the activity of the company must be preceded by bona fide offers for the acquisition thereof.

6.15 The carrying out of the plan of reorganisation must not last longer than ten years and is assured by the a judicially appointed officer (the "*commissaire à l'exécution du plan*) (who oversees the actual performance of the plan) and the administrator to whom the court grants the powers necessary for the execution of the plan.

GERMANY

QUESTION 1

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

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

1.1 Introduction

The concept of personal, civil and criminal liability concerning the directors of German corporations (like a company with limited liability "GmbH" or a stock corporation "AG") is based upon the limited liability of German corporations vis-à-vis its creditors. In the absence of personal liable partners, German corporations are not only limited in terms of personal liability of the shareholders but also in terms of the assets available in the company for distribution to the creditors. Consequently, German corporate law provides for several rules relating to the contribution and the subsequent maintenance of the capital in German corporations. Furthermore, the directors are confronted with even more stringent duties, responsibilities and liabilities once the assets of the company deteriorate, i.e. should the company encounter financial difficulties (the period of the "Twilight Zone"). The access to information by the creditors with respect to the financial situation of the company is restricted. This corresponds with the director's duty to be completely aware of the financial situation of the corporation at any time. Thus, any liability arising during the "Twilight Zone" is mainly imposed on the directors of the corporation, who are the only so-called legal representatives of the corporation. The monitoring duties of directors are less intensive if the distressed company is not a corporation but a partnership consisting of at least one personally liable partner. In this event any duties, responsibilities or liabilities outlined in this Memorandum only apply to a limited extent unless the personally liable shareholder or partner is a company which itself has limited liability.

The German Federal court has no "compassion" with directors lacking knowledge of the company's financial situation not heeding any warning signs concerning the company's deteriorating financial situation. Thus, the essential duties in the "Twilight Period" are applicable to any directors, irrespective of whether they (i) reside abroad, (ii) have an engineering instead of an commercial background, or (iii) act as a chairman of the supervisory board rather than as a manager of the ordinary daily business. This "ideal world" approach indicates the stringent duties imposed on directors during the "Twilight Period". Generally, difficulties of the company do not constitute any liabilities for the shareholders or supervisory board members vis-à-vis third parties. Shareholders or supervisory board members are not even entitled to act on behalf of the company (unless they are directors of the company at the same time). In addition to the appointed and registered directors, German corporate law does not recognise the concept of non-executive directorship, so that generally all appointed directors face the same degree of liability.

1.2 “Illiquidity”, “deficit balance” and “over-indebtedness” as key indicators for the “twilight period”

Certainly, the start and duration of the Twilight Period does not depend on whether a formal insolvency procedure is instituted. Contrary to other European laws, e.g. the laws of the United Kingdom, which rather vaguely refers to points where a director "knew or ought to have concluded that insolvent liquidation is inescapable", German courts and literature have established explicit methods according to which prerequisites indicating the start of the "Twilight Period" will be determined, such prerequisites being illiquidity (i.e. negative cash flow test), impending illiquidity, deficit balance and over-indebtedness (i.e. negative balance sheet or equity test). These key indicators trigger various duties and responsibilities of directors under German corporation, commercial and criminal law, which are also very specific unlike the purpose, e.g. of a "wrongful trading" concept designed to ensure that "directors do everything possible to minimise the potential loss to creditors in anticipation of a insolvent liquidation".

Illiquidity and over-indebtedness are regarded as "absolute bankruptcy reasons" resulting in a duty for the directors to petition for the commencement of insolvency proceedings, while impending illiquidity grants only an option to do this.

Since illiquidity and over-indebtedness are so-called "indefinite legal terms", regulators, courts and German literature have endeavoured to find a precise definition which will determine the start and end of the "Twilight Period", as described below.

1.3 Determination of the twilight period

1.3.1 Illiquidity

The German Insolvency Code stipulates that a debtor is illiquid if he is unable to honour payment obligations when due. Illiquidity will generally be deemed in the event that the debtor has ceased to make payments. The German Federal Court refers to specific circumstances which apparently reveal that the company has ceased to make payments, such as

- declaration of the director of the inability to honour future obligations,
- closing of the business,
- non-payment of significant operating costs, such as wage related costs,
- execution of claims against the company

This warning signs can easily be realised by the directors, so that the requirements concerning their duty to initiate recovery actions are even stronger than in the event of a probable hidden over-indebtedness (see below).

1.3.2 Impending illiquidity

Impending illiquidity will be deemed as existent if a company is presumed to be unable to honour existing payment obligations when they become due. As mentioned above, contrary to the already existing illiquidity and over-indebtedness, impending illiquidity does not constitute an absolute duty of the directors to petition for the commencement of insolvency proceedings. German

insolvency law has introduced impending illiquidity as an option for the petition for insolvency proceedings in order to enable the directors to initiate reorganisation measures, in particular the implementation of a pre-packaged reorganisation plan at an early stage of the insolvency proceedings. Such petition might be combined with an motion for a self-management order which derives from the concept of a "debtor in possession". According to experience with the former German Bankruptcy Code, corporate recovery measures have frequently been interfered with by creditors executing claims by seizing the assets of the estate required to maintain and continue with the business. Following the filing of a petition for the commencement of insolvency proceedings, based on impending illiquidity, protective orders by the court may enjoin any acts of execution on the debtor's assets. However, until now German insolvency courts are rather reluctant to order self-management due to the lack of reliability of those directors who initially may have caused the financial crisis of the company by mismanagement.

With respect to criminal liability, impending illiquidity in addition to already existing illiquidity and over-indebtedness is a constituent element of criminal offences pertaining to insolvency in the German Criminal Code and, therefore, indicates the start of the "Twilight Period" from a criminal law perspective.

1.3.3 Over-indebtedness

While already a deficit balance (i.e. the assets available in a company are less than the registered share capital), to the extent that half of the registered share capital is lost, constitutes the duty of directors to convene a Shareholders' Meeting, the over-indebtedness of a company is an absolute reason for an immediate petition for insolvency proceedings.

This over-indebtedness is not reflected in the ordinary year-end balance sheet, but it may result from a special "over-indebtedness status". Generally, the directors are obligated to carefully monitor the financial situation and institute control devices such as the preparation of monthly interim balance sheets as soon as certain warning signs that the company is experiencing financial difficulties have been revealed, e.g. the aforementioned significant loss of share capital.

In the event that a (interim) balance sheet shows a technical over-indebtedness the directors have to prepare an "over-indebtedness status" in order to verify whether or not the company is actually also over-indebted. In this "status" the assets in the first round would have to be evaluated according to liquidation values. Provided there is a "positive continuation prognosis", the directors may evaluate the assets according to a "going concern". The positive continuation prognosis requires that a detailed and clear medium-term business plan shows that, in operative business and financial matters, the company can survive and prosper in such a way that during this period an insolvency of the company does not occur. Furthermore, it is not sufficient that the directors accept the prognosis as being correct and the results of the planning as "most probable". German courts have always held that the managers must seek the advice of independent outside experts with respect to such a prognosis. These experts must be convinced to the same degree as the management that a positive continuation prognosis exists. In the event that an "over-indebtedness status" which has been drawn up with going concern values still shows a negative equity, the company

has to be regarded as being actually over-indebted and this actual over-indebtedness will constitute the duty to an immediate petition for insolvency proceedings.

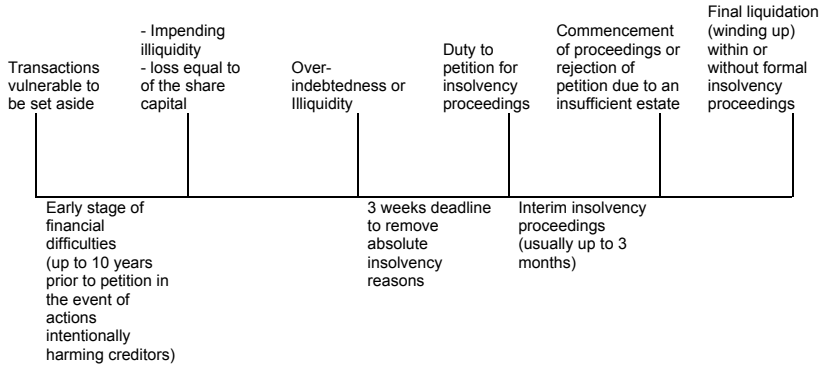
1.3.4 End of the twilight period

As a result of the commencement of insolvency proceedings the directors' right to manage and transfer assets of the company will pass to the insolvency administrator. Although the directors will still be registered with the commercial register, the power to act on behalf of the company has practically ceased to exist. Thus, the directors can no longer be held liable for a violation of rules aiming at the protection of creditors.

In the (not unlikely) event that the petition for the commencement of insolvency proceedings will be rejected due to an insufficient estate (i.e. the assets available in the estate would not be sufficient to cover the costs of the insolvency proceedings) the insolvency court will terminate any protective measures ordered so far, including the aforementioned restrictions of the directors to dispose of the assets. Consequently, the directors will regain control of the company. Since the order rejecting the commencement of insolvency proceedings leads to the dissolution of the company, the directors are now the "born" liquidators who will wind up the company without formal insolvency proceedings. This so-called "lack of assets liquidation" will not be governed by specific rules in addition to the rules pertaining to the "ordinary" voluntary liquidation of companies, which are based on the assumption that the assets would be sufficient to satisfy all creditors. Since the German Insolvency Code, namely the statutes which ensure the equal treatment of creditors of the same rank, are not applicable outside formal insolvency proceedings (according to the prevailing court rulings), there are controversial discussions in German literature as to whether the directors are bound by the principles of the equal treatment of creditors although formal insolvency proceedings involving all creditors have not been instituted by the insolvency court. In practise, the termination of protective measures ordered by the court at the time of the commencement of interim insolvency proceedings, namely the prohibition of execution on the debtors' assets, will result in a resumption of the temporarily restrained execution acts by the respective creditors impeding a proportional distribution of the assets to all creditors according to the principles of equal treatment. Given that the aforementioned deficiencies have been addressed in the reasoning of the bill, leading to the recent replacement of the existing Bankruptcy Code by the new Insolvency Code, any amendments of the statutes pertaining to the liquidation of impecunious companies seem to be unlikely, although a satisfactory solution could not be achieved so far.

1.4 Summary

The following diagram endeavours to illustrate the start and duration of the Twilight Period in terms of civil and criminal liabilities of directors and voidability of actions (see Question 4 below).



QUESTION 2

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2. Actions potentially giving rise to liability for directors

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

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

(i) is any resulting liability against a director civil, criminal or both?;
(ii) can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?;
(iii) will liability attach to individual directors in proportion to their specific involvement?;
(iv) is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director?; and
(v) what defences, if any, will be available in relation to each offence?

2.1 Criminal and civil liability

The German Civil Code provides that any person who violates a statute intended for the protection of others (so-called "protection statutes") is bound to compensate the injured party for any damage arising therefrom. Any criminal statute aiming at the protection of property is deemed as such protection statute, namely statutes which provide for the protection of the creditors of a distressed company attach personal liability to directors who are obligated to compensate losses resulting from a violation of such protection statutes. The following duties directed solely against directors of a distressed company and resulting in criminal as well as civil liability can be found in German Corporate law and German Criminal Code, a summary of each will be considered in turn.

2.1.1 Duty to convene a shareholders' meeting

Pursuant to the German Companies with Limited Liability Act and the German Stock Corporation Act, directors have the duty to convene a shareholders' meeting in the event that, upon preparation of an annual or interim balance sheet, it becomes apparent or it must be assumed by reasonable belief that the company has incurred a loss equal to one-half of the share capital. An action may be brought by the company seeking compensation for damages which could have been avoided by resolution or measures which would have been adopted by a shareholder's meeting if such meeting has been convened in due time.

2.1.2 Duty to petition for the commencement of insolvency proceedings

In practice, the most important event of the civil and criminal liability of directors results from a failure to timely petition for the commencment of insolvency proceedings. Directors of a German company with limited liability, a German stock corporation and a German partnership which consists only of companies with limited liability have the absolute duty to petition for the commencement of insolvency proceedings without undue delay, however, not later than three weeks after the occurrence of illiquidity or over-indebtedness (see above for details as to determination of illiquidity or over-indebtedness). In addition to criminal sanctions, the directors face a civil liability to compensate the company as well as the creditors of the company who suffer a loss caused by the failure of the directors to file the petition in due time.

2.1.2.1 Liability vis-à-vis the company

The Corporate law provisions create a duty of directors to compensate the company for any payments made after the illiquidity has occurred or the over-indebtedness was discovered. This does not apply to payments which were consistent with the due care of a prudent businessman.

2.1.2.2 Liability vis-à-vis the creditors

The German Federal Court has established and recently amended a rather complex method to ascertain the loss suffered by the respective creditor. In calculating the damage compensation, one has to distinguish between creditors already having claims against the company at the time the petition had to be filed, respectively the company which was to become subject to insolvency

proceedings (so-called "old creditors"), and creditors who have entered into business relations with the company after that time (so-called "new creditors").

Assuming that the directors would have filed the petition in due time the "old creditors" would have received a pro-rata distribution based on the assets available at such time. Thus, the total loss suffered by the old creditors has to be calculated by way of a comparison between the assets actually available in the insolvency estate and the assets which would form part of the estate if the directors would have filed the petition in due time. Since the "new creditors" would have refrained from entering into business relations with a company already subject to insolvency proceedings, their loss encompasses the general interest in the agreement. Such loss is probably significantly higher than the loss suffered by the old creditors.

In addition, the German Insolvency Act enables an action to be brought by any person who has made an advance payment in order to avoid that the petition for the commencement for insolvency proceedings will be denied by reason of insufficient assets available in the insolvency estate. The damage compensation comprises the reimbursement of any advanced payments.

2.1.3 Liability vis-à-vis social security authorities

The German Criminal Code imposes sanctions on directors who intentionally fail to transfer social security contributions of employees to the social security authorities. The predecessor statute in the German Criminal Code expressly set out that directors would only become liable in the event that they fail to transfer social security contributions which have been actually deducted and withheld from wages. Literally, the new statute does not longer require such deduction and withholding. Although, some higher regional courts argued that directors could not be held liable for a failure to transfer social contributions despite wages have not been paid to the employees. According to these court rulings something similar to a criminal breach of trust is required which could only be deemed in the event that social contributions will not be transferred despite the corresponding wages have been paid.

The German Federal Court recently reversed one of the aforementioned judgements referring explicitly to the wording of the statute. With this ruling the German Federal Court strengthened the responsibilities of directors vis-à-vis social security authorities significantly which could lead to a conflict of duties urging directors to initiate payments in spite of an (impeding) insolvency. Finally, only the filing of a petition for the commencement of insolvency proceedings would release the directors from their duties to transfer social security contributions.

Notwithstanding, a criminal offence will only be deemed in the event that directors fail to transfer the contributions despite funds are available. Certainly, the German Criminal Code cannot impose sanctions in the event that the transfer of the social security contribution was impossible due to an absolute illiquidity situation. From a very practical perspective it might be advisable for directors to utilise the remaining cash to satisfy outstanding claims of the social security authorities.

With respect to civil liability, the director is obligated to compensate any damages due to the failure to transfer the social contributions which practically results in an obligation to pay compensation in the amount of the social contributions not transferred.

2.1.4 Fraud

Criminal and civil liability due to trading in a fraudulent way will be attached 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 orderer are customary have to be carefully considered by the directors if they are aware of an impending insolvency situation at the time of the conclusion of the agreement and therefore anticipate insolvency proceedings in the near future. Civil liability of directors will be deemed by the German Federal Court in the event that a supplier has been induced by directors to render advance performance without directors having any prospects of being able to pay the consideration.

2.1.5 Crimes pertaining to insolvency

Crimes pertaining to insolvency, if governed in the German Criminal Code, explicitly refer to the "Twilight Period" starting already with impending illiquidity. Alternatively, such criminal statutes apply in the event of an actual over-indebtedness situation of the company, as set forth above. Generally, such crimes relate to conduct which endangers the creditors' rights.
Crimes frequently committed in the period of the Twilight Zone by directors who desperately try to cope with the financial situation and seek to preserve the business by avoiding formal insolvency proceedings, comprise

- any destruction of or damage to assets in a commercially irresponsible manner,
- entering into speculative transactions,
- simulation of the existence of assets,
- violation of the duty to keep books and other statutes of commercial law relating to the accurate disclosure of the current financial situation and the prospect of the business in the books, in particular the balance sheet and the management report,
- endangering the rights of creditors on whose behalf the company holds assets on trust,
- preferential treatment of creditors by way of granting them security or satisfaction to which they are not entitled, and thereby acting intentionally to the detriment of other creditors.

2.2 Civil liability

2.2.1 Liability arising from the causation of an insolvency situation

Generally, directors have to apply the "due care of a prudent businessman" when transacting company affairs. According to German literature, these principles will be violated in the "Twilight Period" in the event that the directors fail to respond immediately to a financial crisis by way of initiating corporate recovery measures. However, since such obligations are not precise, a claim to compensation by creditors can hardly be based on such omission.

2.2.2 Breach of agreement / acting as guarantor vis-à-vis counter-parties

A German Federal Court ruling attaching liability to the directors of a construction company is the subject of a controversial discussion as to whether or not the directors can be held liable for obligations to be fulfilled by the company. The director's liability in the prevailing matter was based on the position of being a guarantor with respect to obligations imposed on the company in connection with an agreement on the provision of collateral to a supplier. The director was made personally liable because he failed to ensure that the security provided by the company could finally be realised by the creditor. As far as the exploitation of personal trust of the directors is concerned, court rulings generally require an additional personal warranty from the director to the effect that his declarations are correct. In this event, the third party relies on the reputation of the director rather than on the reputation of the represented company.

2.2.3 Group liability / piercing the corporate veil

Assuming the director is also a dominating shareholder of the company, the concept of group liability might result in an obligation of the controlling shareholder to compensate any annual net loss due to the misuse of its managerial power. The German Federal Court explicitly states that the concept of "group liability" is also applicable in the event that the shareholder is a natural person and not a legal entity, e.g. the director of the company. The precedent concerned a German company with limited liability having only one shareholder who simultaneously managed the business as the sole director. The court held that the shareholder had misused the concept of limited liability because he actually conducted the business as a sole trader pursuing only his personal interests while intentionally neglecting the affairs of the company. Therefore, the natural person had to be regarded as a "dominating company" analogously to the concept of liability in a group consisting of corporations.

2.2.4 Violation of capital maintenance rules

The capital maintenance rules of the German Companies with Limited Liability Act aim at the preservation of the assets required to maintain the registered share capital and such assets may not be distributed to the shareholders. Any distribution of assets to shareholders during the "Twilight Period" will most likely constitute such redemption of share capital. The directors of the company are personally liable vis-à-vis the company to the extent that assets have been distributed to shareholders in violation of such capital maintenance rules.

2.3 Liability vis-à-vis tax authorities

2.3.1 Obligation to transfer deducted wage taxes

The directors are obligated to deduct wage taxes from the gross amount of wages and to subsequently transfer the deductions to the tax authorities. Since tax deductions from wages are regarded as money held on trust to the benefit of the tax authorities, the failure to transfer such money leads to a personal liability of the directors. In the event that the cash flow is not sufficient to pay the gross amount of wages, the directors are obligated to reduce wage payments to the extent that the wage taxes calculated on the basis of the reduced gross amount of wages can be paid to the tax authorities. .

2.3.2 Preference of other creditors

Generally, the company creditors must be treated equally by the directors during the Twilight Period. With respect to outstanding taxes, the directors are personally liable to the extent that other creditors have been preferred to the detriment of the tax authorities. In the "Twilight Period", directors are required to satisfy the claims of the creditors equally on a pro rata basis in the event that the funds are not sufficient to completely satisfy all creditors.

2.4 Liability in proportion to specific involvement

The rules of procedure, respective service contracts or any oral agreement, frequently provide that directors with an engineering background are primarily responsible for technical matters while financial matters are mainly covered by economists. Therefore, the engineering-related directors are probably not completely aware of the current financial situation of the company. In spite of this, German corporate, commercial or criminal law which govern the specific duties, responsibilities and liabilities of directors, neither expressly attach liability pro rata their specific involvement, nor allocate liability to a specific sphere of responsibilities or areas of practice. Moreover, directors are also responsible for another director's violation of duties, so that practically each director has to use due diligence not only in his own affairs but has to ensure that the other directors will also meet the requirements to the same degree.

However, these principles are not constantly applied, so that a defence like the allocation of spheres of responsibilities to other directors might be available. In particular, the German Criminal Code requires intentional conduct unless expressly negligent conduct is subject to criminal sanctions. Generally, intentional conduct can only be allocated to directors who actually fail to comply with the respective duty. In addition, intentional conduct might be deemed in the event that other directors of the managing board are completely aware of the omission of the other responsible director. Furthermore, court rulings have imposed a supervision duty on the other directors with respect to the compliance of the director actually in charge with the relevant financial matters.

The following outlines whether liability will be attached according to the violation of specific duties by the respective director or whether any director of the management board will face liability irrespective of his involvement.

Actions giving rise to liability	Liability of management board members
Duty to convene a shareholders' meeting	Joint liability
Duty to petition for the commencement of insolvency proceedings	Joint liability
Liability vis-à-vis social security authorities	Liability is allocated to directors who actually failed to transfer the social security to contributions or who were completely aware of the omission of the other responsible director
Fraud /crimes pertaining to insolvency	Liability is allocated to directors who actually commit the crime or who have been completely aware of the crime
Liability arising from the causation of insolvency proceedings	Joint liability
Breach of agreement	Joint liability
Group liability / of corporate veil	Directors who are shareholders as well
Violation of capital maintenance rules	Joint liability; at least negligence of each director required
Liability vis-à-vis tax authorities	Liability is allocated to directors who actually failed to transfer the taxes provided that (i) the allocation of duties was to be made in written form and was to be clear cut (ii) the responsible director is reliable (iii) other directors properly supervised responsible director

2.5 Defences

2.5.1 Transactions to the benefit of the company

Defences regarding any reasonable belief of a director that a transaction is to the benefit of the company are only available if the statutes establishing the liability have a subjective element. This applies to some statutes in the Insolvency Act governing the voidability of transactions (see below). Furthermore, that belief might exclude the assumption of intentional behaviour as required in the Criminal Code. As far as statutes intend to protect specific counter-parties, i.e. as public authorities or creditors dealing with an already illiquid company, that defence is not available.

2.5.2 Actual involvement

As set out above, directors, irrespective of their actual involvement in financial matters and their sphere of responsibilities, have to be generally aware of the company's current financial situation, at any time. The German Federal Court held that the defence as to a lack of knowledge of the company's insolvency situation would only be available if such lack of knowledge is not caused by the directors' negligence in exercising their observation duties and instituting financial control systems.

2.5.3 Return to solvency

The financial crisis of any distressed company needs not be constant but may be temporary. Any duties and responsibilities are related to an insolvency situation, so that solvency at the time of the transaction, cannot result in a liability of directors unless impending illiquidity had to be assumed. Generally, solvency after the transaction does not remedy the violation of duties. In the event of the return to a sustainable financial recovery enabling the company to fully satisfy any claims of creditors, it is unlikely that any criminal prosecution or civil actions based on an past insolvency situation will be commenced. One exemption will be made with respect to a violation of capital maintenance rules. The German Federal court recently held that the crucial point of time is when assets will be distributed to the company shareholder, so that the return to solvency will not cure the violation and any pertinent liability. Similarly, criminal prosecution may even be initiated in the event that creditors did not actually suffer any losses because most of the crimes pertaining to insolvency will be regarded as "abstract strict-liability torts".

QUESTION 3

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3. Other persons involved with the company's affairs 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 Civil and criminal liability of accomplices and participants

As a general rule, liability of other persons involved with distressed companies can be based upon violations of statutes of German law as set forth above provided that they have to be regarded as accomplices or participants of the violation. German civil law imposes a joint and several liability on persons who are jointly liable for a damage irrespective of their degree of involvement while German criminal law allows to reduce the punishment of an aider and abettor. In addition German civil law provides for a joint and several liability even if it cannot be discovered which of several participants has caused the damage through his action. This leads to a shift of the burden of proof to the persons who have caused the damage.

3.2 Other parties liable for the management of distressed companies

3.2.1 De facto directors

The position of a director is clearly defined in German Corporate law setting forth that directors are individuals who were appointed by a Shareholders' Resolution (in the case of a company with limited liability) or a Supervisory Board Resolution (in the case of a stock corporation). Although it is only of a declaratory nature, the directors are obligated to subsequently file their appointment for registration with the commercial register of the competent local court. Contrary to directors who are duly appointed and registered, de facto directors may actually govern and control the management of the company and, therefore, might be deemed to be acting in a directorial capacity. The German Federal Court rather declines to regard any person (partially) involved in the management of the company as a de facto director given that the company will still be managed by the duly appointed and registered director. Moreover, not even management to the same extent and degree as exercised by the registered director would constitute a de facto directorship. The German Federal Court requires that the de facto director (i) is the sole person who conducts the business of the company, or (ii) is in a position to instruct the registered shareholder, or (iii) conducts the business more extensively than the registered director and, therefore, has to be regarded as the "sole" director of the business.

3.2.2 Former directors

Certainly, the directors' liability is based on any conduct exercised during the period of their directorship, so that even former directors will face liabilities regarding their directorship at the time the company was subject to insolvency proceedings. In addition to a potential liability, the German Insolvency Code sets out that former directors who have resigned or otherwise left the position of a director not earlier than two years prior to the commencement of insolvency proceedings, have the same duties of information and co-operation with the insolvency administrator as persons who are still in the position of a director at the time of the insolvency proceedings.

3.2.3 Supervisory board members

In addition to the Management Board members, Supervisory Board members frequently conduct the company's affairs during the Twilight Period. "Dominating"

Supervisory Board members who tend to have a material influence on the company management, e.g. by way of exercising typical management duties, run the risk of being regarded as de facto directors according to the principles set forth above.

Furthermore, Supervisory Board members might face a liability vis-à-vis the company in the event that they fail to exercise the due care of a prudent businessman during the Twilight Period. Supervisory Board members are also liable in case of a participation in the delay to petition for the commencement of insolvency proceedings. In this respect, the following cases are regarded as a breach of duties:

- initiating, respectively tacit toleration, of a deterioration of assets
- non-compliance with more stringent supervising requirements in case of a financial crisis of a GmbH
- failure to seek advice by independent experts
- failure to instruct and to urge the managing directors to petition for the commencement of insolvency proceedings in case of an insolvency situation

3.2.4 Creditors / financing banks

Two key issues continually arise when considering unconnected third party risks providing additional credit during the Twilight Period. Firstly, how safe is it for an unconnected third party in terms of criminal liability to encourage directors to continue with the business despite an insolvency situation by way of providing further (short-term) credit, thereby enabling the directors to meet the most urgent payment duties? Secondly, can an unconnected third party rely on the validity of securities provided by the distressed company in order to secure loans granted during the "Twilight Period"?

There is controversial discussion as to whether or not the granting of loans at the time when the company was to become subject to a formal insolvency proceeding, might encourage the directors not to comply with their duty to petition for the commencement of insolvency proceedings. This might be regarded as a participation of the lender in the crime of an delay to petition for bankruptcy proceedings committed by the directors.

With respect to civil liability of the lender, it has to be evaluated whether the granting of a loan secured by the transfer of assets of the distressed company to the lender finally resulted in a deterioration of the assets of the distressed company compared to the assets available in the insolvency estate in the event that a petition for the commencement of insolvency proceedings would have been filed at the time of granting the loan.

The voidability of a transfer of assets of the distressed company for security purposes will also be discussed in connection with lending strategies of banks. In particular, in the event of so-called bulk securities, such as the assignment of trade receivables of the distressed company, it might be more reasonable from a commercial perspective of the lender to grant further loans or prolong existing loans in order to enhance the value of the assigned trade receivables rather than to cease funding the borrower, which results in an deterioration of assigned trade receivables, because of counter-claims filed by the customers due to the impact

of the commencement of insolvency proceedings and the termination of the business of the distressed company.

So far, such granting or prolongation of loans to distressed companies in the "Twilight Period" have not been subject to criminal prosecution, but rather subject to an action to set aside by the insolvency administrator, with respect to the assets transferred by the distressed company to the lender, in order to secure the loan. The granting of security during the Twilight Period by a distressed company to a lender might be set aside subsequently by the insolvency administrator, because the lender had "no right to claim security in such manner or at such time" (so-called "incongruent correspondence"). The time period in which the transaction has to be effected prior to the petition for insolvency proceedings will be extended in the event that the creditor had knowledge at the time the security was granted that it was detrimental to the insolvency creditors. Generally, granting of security in proximity to the subsequent petition for insolvency proceedings implies an action to the detriment of the insolvency creditors, unless the granting of security is part of a reorganisation plan involving such creditor. However, if security will be granted in consideration for "fresh money" by the bank, such action is generally not to the detriment of the creditors and, therefore, cannot subsequently be set aside by an insolvency administrator.

QUESTION 4

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4. Counterparties dealing with the company during the twilight period

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

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

4.1 Transactions potentially subject to an action to set aside

4.1.1 General rule / heads of challenge

Transactions to the detriment of insolvency creditors effected prior to the commencement of insolvency proceedings might be subject to an action to set aside. Transactions will be deemed as detrimental in the event that either the liabilities of the debtor in insolvency proceedings have been increased or the assets available in the insolvency estate have been reduced.

The legal term "transactions" encompasses all acts which either gave or made it possible for a counter-party dealing with the distressed company to receive security or satisfaction. The German Insolvency Code distinguishes between

(i) congruent correspondence,
(ii) incongruent correspondence,
(iii) directly detrimental transactions,
(iv) intentionally harmful actions,
(v) performance without consideration
(vi) redemption of loans in lieu of capital contributions

as potential heads of challenge. For each transaction a different time limit in respect of voidability is applicable. The time limits cover transactions which are effected in the month prior to the petition for commencement, as well as transactions which are effected after such petition (in the event of merely incongruent correspondence) up to transactions effected ten years prior to the petition for commencement (in the event of intentionally harmful actions).

From the point of view of a counter-party dealing with the company during the Twilight Period, it is decisive whether;

(i) the counter-party had knowledge of the illiquidity of the company at the time of the transaction,
(ii) the creditor had knowledge of the petition for commencement of insolvency proceedings at the time of the transaction,
(iii) the creditor had equivalent knowledge on circumstances which compel the conclusion with respect to the illiquidity or the petition for commencement of insolvency proceedings,
(iv) the counter-parties are persons related to the distressed company and, therefore, will be deemed as having such knowledge,
(v) the counter-party had knowledge of circumstances which compel the conclusion that the transaction was detrimental to the insolvency creditors,
(vii) the counter-party had knowledge of the intent of the distressed company to harm its creditors, such knowledge will be presumed if the counter-party had knowledge of an impending illiquidity and of the fact that the transaction was harmful to creditors, and
(viii) the counter-party received any performance without payment or any other consideration.

4.1.2 Voidability of transactions outside of insolvency proceedings

Any of the creditor protection measures outlined above are applicable accordingly, even if formal insolvency proceedings will not be commenced following the Twilight Period. Such voidability of transactions is governed in separate statutes, i.e. the Avoidance Act ("Anfechtungsgesetz"). The claims to avoidance have to be filed by a creditor and not by an insolvency administrator. In the event that execution in the assets of the debtor will not lead to complete satisfaction of the creditor, or it has to be assumed that any execution will not be successful, the creditor is entitled to file an action to set aside. Certainly, the time period in which an action might be attacked also cannot refer to the petition for the commencement of insolvency proceedings. Therefore, it is decisive, whether the transaction has to be exercised by a creditor with the competent court within a specific time period prior to the filing of an action to set aside.

4.2. Defences

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 such transaction was also to the benefit of the insolvency creditors. In determining whether or not any transaction was to the benefit of the insolvency creditors, only the assets in the insolvency estate available for distribution to the creditors will be considered. If any transaction exercised in the "Twilight Period" resulted in the granting of security of satisfaction to a creditor who could not claim security or satisfaction at that time (since he was merely an ordinary or even subordinate insolvency creditor), such transaction will not be to the benefit of the insolvency creditors in subsequent insolvency proceedings.

4.2.2 Lack of knowledge of the company's insolvency position

As far as any transaction requires,

(i) knowledge of the illiquidity situation, or
(ii) knowledge of any circumstances that compel the conclusion as to the illiquidity situation, or
(iii) the creditor had knowledge that the transaction was detrimental to the insolvency creditors, or the knowledge of circumstances that compel the conclusion in this respect any lack of knowledge of the current financial situation of the company by the creditor has to be regarded as a permissible defence.

4.2.3 Solvency of the company at the time of or after the transaction

Since any action exercised prior to the commencement of insolvency proceedings might be subject to an action to satisfy, the German Insolvency Code does not refer to an insolvency situation at the time of or after the transaction, but refers to a specific time period which leads to the conclusion that the company is in the Twilight Period, irrespective of whether or not the company was solvent at the exact time when the transaction was actually exercised.

4.2.4 Other defences

Transactions by the debtor with the intent of harming its creditors can be attacked within the last ten years prior to the petition for commencement of insolvency proceedings. Therefore, a lack of intention to prefer a creditor has to be regarded as a permissible defence in this respect. However, since the German Insolvency Code does not require any intention to prefer creditors with respect to the remaining potential heads of challenge, but rather considers mere knowledge of the illiquidity situation of a company by the creditor who benefits from the transaction as sufficient, the defence of a lack of intention to prefer is limited.

QUESTION 5

5. Enforcement

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

5.1 Creditors / shareholders / public authorities / other third parties

Civil actions against directors will generally be brought by parties suffering damages due to a violation of duties irrespective of whether they are suppliers, lenders, shareholders or any other third party dealing with the company. In addition, tax authorities and social security authorities will file claims arising from the failure of the directors to transfer taxes and social security contributions.

Shareholders liable to make contributions to the insolvency estate can hardly claim compensation from the directors since their civil liability is normally based upon (i) a violation of capital maintenance rules by way of a prohibited redemption of contributions, or (ii) a misuse of managerial power in favour of the controlling shareholder. Consequently, the shareholders are only liable in the amount of the received payments they have not been entitled to.

5.2 Insolvency administrator as office holder for the insolvency estate

5.2.1 Joint damages of creditors

Upon the commencement of formal insolvency proceedings, the German Insolvency Code states that claims for damages by insolvency creditors who have suffered by such creditors jointly and severally as a result of the reduction of the insolvency estate (joint damages) may be claimed only by the insolvency administrator during the insolvency proceedings. As outlined above (see C.I.2), in the event of a delay of the petition for commencement of insolvency proceedings such joint damages will be suffered by the so-called "old creditors" since the diminution of the insolvency estate will lead to a reduction of the pro rata distribution following the realisation of the assets of the insolvency estate. In contrast, the so-called "new creditors" do not suffer joint damages due to a reduction of the insolvency estate, but have claims to the negative interest resulting from the respective agreement. Consequently, according to prevailing opinions in legal literature, such individual damages have to be assessed according to the respective agreement and, therefore, can only be claimed by the respective creditor.

5.2.2 Enforcement of claims in his capacity as office holder for the company

Upon the commencement of the insolvency proceedings, only the appointed insolvency administrator is entitled to represent and act on behalf of the company. Therefore, claims of the company, irrespective of whether or not they already existed at the time of the commencement of the insolvency proceedings (even before the start of the Twilight Period), or will arise following the commencement

of the insolvency proceedings in the course of the continuation of the company's business, can only be enforced by the insolvency administrator. Further, only the insolvency administrator is entitled to void transactions by an action to set aside, claiming the return of anything that was transferred or disposed of in other ways from the assets of the company by means of a voidable transaction to the company. Since a German corporation like company with limited liability or a stock corporation will be dissolved upon the commencement of insolvency proceedings (unless the shareholders resolve upon a continuation of the company following the successful implementation of a reorganisation plan), the insolvency administrator will not literally be regarded as an office holder for the company, but represents the insolvency estate consisting of any assets that belong to the company at the time of the commencement of the proceedings as well as acquired during the course of the insolvency proceedings.

QUESTION 6

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6. Remedies: orders available to the domestic court

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

6.1 Introduction

In respect of the aforementioned actions giving rise to liability of directors, a German civil court will order directors to pay compensation to the party who suffered the damages while a German criminal court will sentence the directors to imprisonment or fines in accordance with the level of personal guilt. As to civil liability, compensations might be claimed either by the company (i.e. the insolvency estate represented by the insolvency administrator as office holder (see above), or by a creditor, shareholder, public authority or any other third party dealing with the company. Transactions which are successfully challenged by the insolvency administrator will result in a court order to return the assets to the insolvency estate. Since the German Insolvency Code provides for a detailed ranking of pre-petition claims and administrative claims, an order postponing debt owed by a company to rank after other debts is not required.

6.2 Overview

Actions giving rise to liability	Legal consequences / orders available to the court
Duty to convene a shareholders' meeting	Damage compensation to be paid by directors to the company (civil liability) Imprisonment up to 3 years or fine
Duty to petition for the commencement of insolvency proceedings	Damage compensation to be paid to "new creditors" (see above) or to insolvency administrator (joint damage) Imprisonment up to 3 years or fine
Liability vis-à-vis social security authorities	Damage compensation to be paid to authorities Imprisonment up to 5 years or fine
Fraudulent trading /crimes pertaining to insolvency	Damage compensation to be paid to crime victims Imprisonment up to 5 years or fine Disqualification from acting as director for 5 years following the time when sentence became final by virtue of law
Liability arising from the causation of insolvency proceedings	Damage compensation to be paid to company
Breach of agreement providing security	Damage compensation to creditor who were to be secured
Group liability / Piercing the corporate veil	Damage compensation to be paid to company
Violation of capital maintenance rules	Damage compensation to be paid to company
Liability vis-à-vis tax authorities	Damage compensation to be paid to authorities

QUESTION 7

7. Duty to co-operate

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

The German Insolvency Code imposes extensive duties of information and co-operation of the debtor with respect to insolvency proceedings vis-à-vis the insolvency administrator. In the event that the debtor is a corporation, such duties apply analogously to all members of the executive or supervisory boards. In addition to the members on such boards, other parties involved in the insolvency proceedings such as creditors in possession of security or any other parties to whom assets of the insolvent companies were transferred by way of an potential voidable transaction can be compelled to co-operate with the insolvency administrator.

Any resignation of directors in proximity to the commencement of insolvency proceedings will not result in any discharge from the duties to provide information relevant to the insolvency proceeding to the insolvency court, the insolvency administrator or the creditors' committee. Thus, information and co-operation duties apply to persons, who left any of the aforementioned positions not earlier than two years prior to the commencement of the insolvency proceeding.

As to the level of co-operation, the German Insolvency Code states that the directors shall assist the insolvency administrator in the performance of his duties and furthermore shall make themselves available at the order of the court for this purposes. Any aforementioned duty may be enforced by the insolvency court, ordering the directors to make an affidavit to the effect that the information provided is correct and complete. Finally, the court may force the debtor to appear and could take the director into custody if the director refuses to comply with his information and co-operation duties.

In practice, the aforementioned information and co-operation duties can hardly be distinguished from rendering services by a director to the extent of a service or employment contract. However, according to prevailing opinions in legal literature, the directors are not obligated to render their full working strength without remuneration.

Clearly, the German Insolvency Code does not recognise the defence of privilege against self-information with regard to the aforementioned information and co-operation duties, so that directors are obligated to disclose even facts which are likely to result in the prosecution of a crime or administrative offence. However, any use of such information in criminal proceedings requires the consent of the director.

QUESTION 8

8. Appeals and limitation periods

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

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

8.1 Limitation periods

Actions giving rise to liability	**Limitation periods** a) Limitations on prosecution b) Limitations on enforcement of claims
Duty to convene a shareholders' meeting	a) 5 years as soon as the crime is completed b) 3 years starting as soon as the injured party has knowledge of injury
Duty to petition for the commencement of insolvency proceedings	a) 5 years starting as soon as the duty of directors to petition for insolvency proceedings ceased to exist (e.g. if over-indebtedness has been removed) b) 3 years starting as soon as the injured party has knowledge of injury 5 years with respect to claims to reimbursement of advance payments made in order to cover costs of proceedings
Liability vis-à-vis social security authorities	a) 5 years starting as soon as the duty of directors to petition for insolvency proceedings ceased to exist (example given if over-indebtedness has been removed) b) 3 years starting as soon as the injured party has knowledge of injury

Fraud /crimes pertaining to insolvency	a) 5 years starting as soon as the duty of directors to petition for insolvency proceedings ceased to exist (example given if over-indebtedness has been removed) b) 3 years starting as soon as the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period
Liability arising from the causation of insolvency proceedings	b) 3 years as soon as the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period (civil liability)
Breach of agreement	b) 30 years, unless shorter limitation periods apply
Group liability / Piercing the corporate veil	b) 30 years starting when the claim is arising
Violation of capital maintenance rules	b) 5 years starting at the time of the violation
Liability vis-à-vis tax authorities	b) 4 years regarding tax assessment
Disqualification of directors	Disqualified as managing director for 5 years following the time when sentence became final, unless court ruling imposing disqualification provides for a longer time period

8.2 Appeals

Generally, any decision of the first instance court in penal or civil proceedings might be the subject of an appeal, unless the civil courts of the first instance orders damage compensation which does not exceed the amount of DM 1,500.

As outlined above, any disqualification of directors result from a sentence or side sanctions ordered by a criminal court, the order of which might be appealed against.

QUESTION 9

9. Foreign corporations

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

Any legal provisions and procedures outlined above apply to domestic corporations which do not have a personally liable shareholder or partner. With respect to liabilities vis-à-vis public authorities and liabilities arising from any crimes pertaining to insolvency and any breach of agreements, the aforementioned legal provisions apply irrespective of the legal form and legal seat as long as the business transactions of the company are operated in Germany.

QUESTION 10

10. Insurance

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

10.1 Coverage available

"Directors and Officers" insurance covering the exposure of directors of German corporations are emerging in the German insurance market. Introduced by the U.S. and British insurance companies which have a substantial background in their respective foreign market, an urgent need of directors to protect themselves against personal liability which may arise in connection with the aforementioned actions, has been caused by a more proactive attitude of insolvency creditors to recover their losses from the directors. It is expected that the German courts will strengthen their demands as to the compliance of directors with their duties, namely their duty to petition for the commencement of insolvency proceedings, respectively to be aware of the current financial situation of the company resulting in such duty. On the other hand, any premature petition for the commencement of insolvency proceedings is also not advisable because this could be regarded as a general violation of the managing duties of directors and, therefore, could lead to compensation claims of the company.

Following the approach of probably all German insurance companies, the coverage of risks does not include intentional or "consciously" negligent misconduct of directors.

Furthermore, according to the common practise in the U.S., the insurance companies used by the company directors or executive staff tend to exclude protection against internal liability vis-à-vis the company. Such exclusion of internal liability is historically based on the risk of so-called shareholder derivative lawsuits, i.e. shareholders claiming compensation on behalf of the company from their directors. Despite the fact that such lawsuits are generally not recognised in Germany, insurance companies fear potential abuse of such coverage which could enable the directors to act collusively with the shareholders in order to enrich the assets of the company. However, the exclusion of the exposure arising from internal liability is not a satisfactory solution for directors from a practical perspective because various cases of civil liability result in a duty to compensate the company and not the outstanding creditors.

In summary, protection is only available with respect to claims of outstanding creditors arising from a merely negligent violation of duties. However, even this protection may prove not to be effective bearing in mind that in practise, the dividing line between "merely" negligence on the one side, and "conscious" negligence or "contingent" intention on the other side, is difficult to determine. Directors may already act "consciously" negligent if they consider the existence of a financial crisis as "probable". As far as insolvency-related crimes resulting in a civil liability are concerned, criteria and procedure determining illiquidity and over-indebtedness are complex, so that the misconduct of directors in this respect is "slightly" negligent rather than "consciously" negligent or intentional. The failure to transfer deducted taxes or social contributions will be regarded as intentional or "consciously" negligent conduct if the director is completely aware of the circumstances constituting his duty as well as of the duty itself.

10.2. Claims to reimbursement or indemnification

In addition to insurance protection, indemnification for third party claims or company claims against the directors might be considered as an option.

Certainly, directors are entitled to reimbursement or indemnification by the company to the extent that the compensations claimed against the directors were to be paid out of the assets of the company, such as wage taxes or social security contributions.

The German Federal Court held that a company with limited liability might indemnify directors of a company with limited liability with respect to claims of third parties due to the implementation of instructions of shareholders urging directors to violate their duties. Apart from this, general indemnification by the company on a contractual basis is only permissible as far as this indemnification to be paid from the company assets will not endanger claims of outstanding creditors. This principle is applicable with respect to third party claims as well as to claims of the company against its directors.

Due to the punitive character, directors cannot recover any fines imposed in the course of criminal prosecution.

QUESTION 11

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

11.1 Directors incurring further credit

Certainly, continued demand of funds in the Twilight Period, in particular fresh money to avoid illiquidity and/or over-indebtedness, compels directors to seek further funding either by shareholders or third parties, i.e. lenders or suppliers. As mentioned above, directors would commit a fraud and become personally liable vis-à-vis third parties in the event that they incur further credit by way of encouraging lenders or suppliers to grant additional loans or to render advance performance without directors having any prospects of being able to redeem the loans or pay the consideration. Moreover, directors exploiting their own personal trust rather than acting merely as a representative of the distressed company when incurring further credit vis-à-vis third parties, might become personally liable in the event that the security provided could finally not be successfully realised by the creditor due to an action to set aside or for practical reasons.

11.2 Counter-party risks

Shareholders providing loans at a time when a prudent businessman would have made contributions into the company's equity capital instead granting a loan, can only claim redemption of the loan in insolvency proceedings as so-called subordinate insolvency creditors, i.e. following the complete satisfaction of the ordinary non-subordinated insolvency creditors. The aforementioned financial situation of a distressed company will be deemed to exist once the company is no longer capable of incurring further credits which accrue interest in accordance with market prices. Alternatively, loans will be regarded as replacing equity in the event that any other unconnected third party acting as a reasonable creditor, would decline to grant loans according to the same terms as the shareholder actually did. Any redemption of loans granted in lieu of equity might be set aside by the insolvency administrator if the redemption was effected in the last year prior to the petition for the commencement of insolvency proceedings or following such petition. Security provided for the redemption of a loan in lieu of capital might even be set aside if it was effected in the last ten years prior to the petition for the commencement of insolvency proceedings or following such petition.

As outlined above, the lending strategies of banks are the subject of a controversial discussion with respect to the voidability of a transfer of assets by the distressed company serving as security for loans granted by lenders in the "Twilight Period".

Notes

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 (i) Under the Indian Law, insolvency proceedings can be initiated in respect of a company under two statutes, Companies Act, **1956 (hereinafter referred to as the `1956 Act')** and Sick Industrial Companies (Special Provisions) Act, 1985 **(hereinafter also referred to as `SICA')**. Therefore, the length of the twilight period during which Directors and others involved in management of the company could be held personally liable has to be understood in the context of the above referred two legislations.

(ii) SICA makes it mandatory for the company whose net worth is completely eroded, to make a reference to Board for Industrial and Financial Reconstruction **(hereinafter also referred to as `BIFR')** for determination of appropriate measures to be adopted.[1] Even Central/State Government, Financial Institutions and Scheduled Banks having stake in such company can inform BIFR of erosion of its networth. If on an inquiry into such reference, BIFR formulates the opinion that it is not possible for the company to make its networth exceed its accumulated losses within a reasonable time, and that it is just and equitable that the company be wound up, it records such opinion and forwards it to the High Court under whose jurisdiction the company is registered for initiation of winding up proceedings.[2]

(iii) Under 1956 Act, on grounds mentioned therein[3], a proceeding for winding up of a company can be initiated against a company before the High Court under whose jurisdiction the said company is registered.

Sick Industrial Companies (Special Provisions) Act, 1985 (SICA)

1.2 (i) Under SICA, no definite period has been defined during which the 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. Such a period and liability of Directors and other officers may vary depending upon the factors discussed below.

(ii) There is an obligation caused on the Board of Directors to intimate to BIFR, when fifty percent of its networth is eroded at the end of a financial year[4]. If this provision is not complied with, all the Directors and other officers are

[1] Section 15 of SICA.
[2] Section 20(1) of SICA.
[3] Section 433 of 1956 Act.
[4] Section 23 (1) of SICA.

liable to be punished with imprisonment not to be less than six months and which may extend upto two years and with fine.[5] Once intimation of erosion of fifty percent of networth is made, the BIFR has the authority to call for periodic information from such company and thus the actions of Directors get to be monitored. If such erosion of fifty percent has occurred repeatedly, on every such erosion, intimation has to be made to BIFR. Thus, Directors and other officers continue to be under some kind of supervision of BIFR as long as the erosion does not get reduced to less than fifty percent. If such erosion of fifty percent occurs during the immediate preceding four years, FIs, Banks and Central/State Government can also inform BIFR and in such case, BIFR holds an inquiry and if it forms an opinion that it is just and equitable that the company be wound up, recommendations are made to the concerned High Court. The twilight period comes to an end as and when the High Court passes an order of winding up.

(iii) If a reference is made by a company on erosion of its complete networth, a detailed inquiry is held by BIFR into the financial affairs of the company to find out if the said company is genuinely sick or that it has manipulated its accounts to render itself sick to avail the protections under SICA. The secured creditors of the company are also heard. The investigation at this stage is not necessarily limited to the immediately preceding financial year at the end of which the erosion has occurred. If doubts are raised, a comprehensive inquiry can be held into the financial affairs of the company. Special Investigative Audit is also directed if the accounts are large and doubts too many. If at the end of such inquiry, it is found that the company was mismanaged, funds diverted, accounts manipulated, assets sold at under valued prices, interest of company was compromised by Directors and/or any of its officers, BIFR and Appellate Authority for Industrial and Financial Reconstruction **(hereinafter also referred to as `AAIFR')** can direct that such a company is not sick and can not avail benefits of SICA and such Directors/Officers should not be granted financial assistance by FIs and Banks in future. The proceedings lapse and so does the jurisdiction of BIFR though it can inform the Central Government if any offence under the 1956 Act or any other Act have been committed, for taking suitable action, if necessary.

(iv) If BIFR finds that the company is genuinely sick, it holds a further inquiry and explores means to find out if it is possible for the company to make its networth exceed its accumulated losses within a reasonable time, and if it formulates an opinion that such possibility does not exist and that it is just and equitable that the company be wound up, it records such opinion and forwards it to the High Court under whose jurisdiction the company is registered for initiation of winding up proceedings. In such case, the jurisdiction of BIFR cease to exist and it has no powers beyond what has been stated sub para (iii) of para 1.2 above. The High Court initiates formal winding up proceedings on receipt of such opinion from BIFR and on such initiation, twilight period comes to an end. During this period, if BIFR finds that the company has attempted to deal with the assets of the company in a manner detrimental or prejudicial to its interest, it can initiate action against its Directors and/or responsible officials.

[5] Section 23(5) of SICA.

(v) The twilight period is much longer under SICA if a scheme for rehabilitation is approved and sanctioned. The liability of Directors and other officers is also much more stringent. If a scheme is sanctioned and during the course of its implementation, it is found that any Director or an officer has misapplied, or retained, or become liable or accountable for any property of the company or has been guilty of misfeasance, malfeasance or non feasance or breach of trust, it can direct repayment or restoration of money or property as the case may be or to contribute such sum as may be ordered by way of compensation.[6] The twilight period would continue till such time the company is declared to have regained its net worth and is out of purview of SICA. However, it is not certain that in such case where the company does not ultimately go into liquidation and insolvency proceedings do not become necessary, whether the period preceding that could actually be termed as twilight period inspite of transactions during this period becoming vulnerable. However, if the sanctioned scheme fails and ultimately, BIFR is left with no other option but to recommend for winding up, the position would be different and obviously, the entire period during which scheme was in operation would be termed as twilight period.

Companies Act, 1956 (1956 Act)

1.3 (i) In case of winding up proceedings presented under the 1956 Act (excluding those which are taken up on recommendations of BIFR under SICA) including those for voluntary winding, the term of twilight period could be determined with lesser difficulty. Formal insolvency proceedings could be stated to have started when a winding up petition is admitted. Mere presentation of winding up petition and/or notice of court thereon to the company sought to be wound up is not initiation of winding up proceedings though, the date of presentation becomes very relevant when the company is actually ordered to be wound up later as would be clear from the following submissions.

Fraudulent Preference[7]

(ii) Any transfer of property, movable or immovable, delivery of goods, payment, execution or other act relating to property made, taken or done by or against a company within six months before the commencement of its winding up which, had it been made, taken or done by or against an individual within three months before the presentation on any insolvency petition on which he is adjudged insolvent, would be deemed in his insolvency a fraudulent preference, shall in the event of the company being wound up, be deemed fraudulent preference of its creditors and be invalid accordingly.

For the purpose of above provision, the presentation of a petition for winding up in the case of a winding up by or subject to the supervision of the Court, and the passing of a resolution for winding up in the case of a voluntary winding up, shall be deemed to correspond to the act insolvency in the case of an individual.

[6] Section 24 of SICA
[7] Section 531 of 1956 Act.

Where, in the case of a company which is being wound up, anything made, taken or done in invalid as a fraudulent preference of a person interested in property mortgaged or charged to secure the company's debt, the person preferred is subjected to the same liabilities, and have the same rights, as if he had undertaken to be personally liable as surety for the debt, to the extent of the mortgage or charge on the property or the value of his interest, whichever is less. The value of the said person's interest is determined as the date of the transaction constituting the fraudulent preference, and is determined as if the interest were free of all encumbrances other than those to which the mortgage or charge for the company's debt was then subject.

On any application made to the Court with respect to any payment on the ground that the payment was a fraudulent preference of a surety or guarantor, the courts have jurisdiction to determine any questions with respect to the payment arising between the person to whom the payment was made and the surety or guarantor and to grant relief in respect thereof, notwithstanding that it is not necessary so to do for the purpose of the winding up, and for that purpose may give leave to bring in the surety or guarantor as a third party as in the case of a suit for the recovery of the sum paid.[8]

This provision applies, with the necessary modifications, in relation to transactions other than the payment of money as it applies in relation to payments of money.

Avoidance of voluntary transfer.[9]

(iii) Any transfer of property, movable or immovable, or any delivery of gods, made by a company, not being a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrance in good faith and for valuable consideration, if made within a 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, shall be void against the Liquidator.

Transfer for benefit of all creditors to be void.[10]

(iv) Any transfer or assignment by a company of all its property to trustee for the benefit of all its creditors is void.

Effect of floating charge.[11]

(v) Where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, is unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to the; amount of any cash paid to the company at the time of, or

[8] Section 533 of 1956 Act.
[9] Section 531A of 1956 Act.
[10] Section 532 of 1956 Act.
[11] Section 534 of 1956 Act.

subsequently to the creation of, and in consideration for, the charge, together with interest on that amount at the rate of five per cent per annum or such other rates may for the time being be fortified by the Central Government in the Official Gazette.

Avoidance of transfers, etc., after commencement of voluntary winding up.

(vi) In the case of a voluntary winding up, any transfer of shares in the company, not being a transfer made to or with the sanction of the Liquidator, and any alteration in the status of the members of the company, made after the commencement of the winding up, shall, unless the Court otherwise orders, be void.

QUESTION NO. 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?

The liability of directors in the present context can be discussed under two sub-heads, one which pertains to and is attracted only during the course of the winding-up proceedings or to say so its insolvency proceedings and the other set of liabilities being general in nature, which continue during the entire term of directorship regardless of whether the company concerned is undergoing insolvency proceedings or not. Hence, we discuss the above question under two separate sub-heads, namely, Specific Liability and General Liability.

· **Specific liability**

1. Misconduct By Officers of Companies in Liquidation[12]

1.1 A past or present officer of a company commits an offence if he -

(a) does not, to the best of his knowledge and belief, fully and truly discover to the Liquidator all the property, movable and immovable, of the company, 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 the business of the company;

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

(c) does not deliver up to the Liquidator, or as he directs, all such books and papers of the company as are in his custody or under his control and which he is required by law to deliver up;

(d) within the 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 one hundred rupees or upwards, or conceals any debt due to or from the company;

(e) within the 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 one hundred rupees or upwards;

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

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

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

(i) within the twelve months 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;

(j) within the 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;

[12] Section 538 Companies Act, 1956

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

(l) after the commencement of the winding up or at any meeting of the creditors of the company within the twelve months 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;

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

(n) within the twelve months next before the commencement of the winding up or at any time thereafter, under the 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;

(o) within the 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 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;

1.2 If any of the above from (a)-(p) are satisfied:

(i) The liability under this provision is criminal.

(ii) A person guilty of this offence is liable to imprisonment or a fine or both.

(iii) The gravity of the misconduct is demonstrable from the term of imprisonment or the extent of the fine that is imposed. In exercising its punitive jurisdiction, the court(s) hereunder do not seek to compensate the company concerned. The officer shall be punishable, in the case of any of the offences above mentioned in sub-paras (m), (n) and (o), with imprisonment for a term which may extend to five years, or with fine, or with both, and, in the case of any other offence, with imprisonment for a term which may extend to two years, or with fine, or with both;

(iv) As can be gathered from the above that certain acts of the officers even if having been committed within 12 months immediately preceding the commencement of the winding up proceedings could constitute offences of misconduct, hence during twilight period.

(v) It shall be a good defence -

(a) to a charge under any of the above mentioned sub-paras (b), (c), (d), (f), (n) and (o), if the accused proves that he had no intent to defraud; and

(b) to a charge under any of the above mentioned sub-paras (a), (h), (i) and (j), if he proves that he had no intent to conceal the true state of affairs of the company or to defeat the law.

2. Defrauding of Creditors[13]

2.1 The offence is committed by an officer of a company which is subsequently ordered to be wound up by the Court or which subsequently passes a resolution for voluntary winding up, if he –

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

(b) with intent to defraud creditors of the company, 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 judgement or order for payment of money obtained against the company, or within two months before that date;

2.2 (i) The liability under this provision is criminal. Hence, the answers to (ii) and (iii) are as set out in para 1.2 above, subject to, however that in the present case the guilty officer shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine.

(ii) There is no hard and fast rule as to maximum gap between the impugned transaction and the order of winding up by the Court or passage of a resolution for voluntary winding up. It all depends on the evidence to be adduced so as to prove that when the transaction took place, it was within the knowledge of the officer that the company was bound or likely to go in for liquidation.

(iii) Absence of mens rea i.e. absence of intention to defraud is the available defence.

3. Maintenance of Improper Accounts[14]

3.1 (i) 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 guilty of the offence under this provision.

[13] Section 540 Companies Act, 1956
[14] Section 541 Companies Act 1956

(ii) It shall be deemed that proper books of account have not been kept in the case of any company, if there have not been kept -

(a) such books or accounts as are necessary to exhibit and explain the transactions and financial position of the business of the company, including books containing entries made from day to day in sufficient detail of all cash received and all cash paid; and

(b) where the business of the company has involved dealings in goods, statements of the annual stock takings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

3.2 (i) The liability under this provision is criminal. Hence, the answers to (ii) and (iii) are as set out in para 1.2 above, subject to, however that in the present cases the guilty officer shall be punishable with imprisonment for a term, which may extend to one year.

(ii) The offence must have been committed throughout the period of 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.

(iii) The defence available to the officer is to show that he acted honestly and that in the circumstances in which the business of the company was carried on, the default was excusable.

4. Falsification of Company's Books[15]

4.1 An offence under this provision is committed, if any officer or contributory of a company, which is being wound up, with intent to defraud or deceive any person,

(a) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

(b) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company.

4.2 (i) The liability under this provision is criminal. Hence, the answers to (ii) and (iii) are as set out in para 1.2 above, subject to, however that in the present case the guilty officer shall be punishable with imprisonment for a term which may extend to seven years and shall also be liable to fine.

(ii) This offence applies when the company is being wound up.

(iii) Absence of mens rea i.e. absence of intention to defraud or deceive any person by virtue of commission of the above acts is the available defence.

[15] Section 539 Companies Act 1956

5. Fraudulent Conduct of Company's Business[16]

5.1 The 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 persons, or for any fraudulent purpose. The 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.

5.2 This applies where a company is being wound up and it is shown that the business of the company as 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, the same as in English Law and are as follows:

- there has to be an insolvent liquidation in progress;
- there has to have been dishonesty in the running of the business as that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose;
- as dishonesty is involved, the standard of proof is that of 'beyond reasonable doubt', even in a case of civil liability;
- it applies to persons who are "knowingly parties" to the fraudulent trading which may be both wider and narrower than the concept of director/shadow director for wrongful trading, but it could in theory, be wide enough to catch a financier who funded the fraudulent trading knowing that it was being done dishonestly.

5.3 (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 but it may also include a punitive element in the award of damages made.

(iii) As indicated in (ii) above, there should be an element of proportionality albeit that the court's discretion is very wide.

(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.

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

[16] Section 542 Companies Act 1956

proving dishonesty and, now, wrongful trading will in most sets of facts be easier to prove.

6. Delinquency, Breach of Trust & Misfeasance: Directors and others[17]

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.

6.2 (i) The liability under this provision is civil.

(ii) A person guilty of this offence can be compelled by the Court to repay or restore the money or property or any part thereof respectively, 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, as the Court thinks just.

(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) The proceeding can be instituted under this provision within five years from the date of the order for winding up, or of the first appointment of the Liquidator in the winding up, or of the misapplication, retainer, misfeasance or breach of trust, as the case may be, whichever is longer.

(v) 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.

7. Misfeasance Proceedings[18]

7.1 An offence is made out, if, in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal, it appears to the Board for Industrial and Financial Reconstruction 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–

(a) has misapplied or retained, or become liable or accountable for, any money or property of the sick industrial company; or

(b) has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust in relation to the sick industrial company,

[17] Section 543 Companies Act 1956
[18] Section 24 Sick Industrial Companies (Special Provisions) Act, 1985

7.2 (i) The liability under this provision is civil.

(ii) A person guilty of this offence can be directed 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 sick industrial company or the other person, entitled thereto by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Tribunal thinks just and also report the matter to the Central Government for any other action which that Government may deem fit. Further, 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 industrial 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 a bona fide purpose 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, during a 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).

(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) The proceeding can be instituted under this provision in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal of a sick company by the Tribunal.

(v) There is a defence where the director has acted honestly and reasonably and the court concludes that he ought fairly to be excused.

8. Directors and Managers with unlimited liability[19]

8.1 In the winding up of a limited company, any director, or manager, whether past or present, whose liability is, under the provisions of this Act, unlimited, shall, in addition to his liability, if any, to contribute as an ordinary member, be liable to make a further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.

Exceptions:

(a) a past director or manager shall not be liable to make such further contribution, if he has ceased to hold office for a year or upwards before the commencement of the winding up;

(b) a past director, or manger 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;

[19] Section 427 Companies Act 1956

(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.

9. Offences under SICA[20]

9.1 If any person violated the Scheme sanctioned by BIFR/AAIFR or any order passed by BIFR/AAIFR or furnished false statement and/or evidence under SICA, is liable to be punished with simple imprisonment for a term which may extend up to three years and shall also be liable for fine.

· **General disability and liability**

1. Removal of Managerial Personnel[21]

· Where in the opinion of the Central Government there are circumstances suggesting that any person concerned in the conduct and management of the affairs of a company is or has been in connection therewith guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations and functions under the law, or breach of trust; or that the business of a company is not or has not been conducted and managed by such person accordance with sound business principles and prudent commercial practices; or that a company is or has been conducted and managed by such person in a manner which is likely to cause, or has caused, serious injury or damaged to the interest of the trade, industry or business to which such company pertains; or that the business of the company is or has been conducted and managed by such person with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest, the Central Government may state a case against the person aforesaid and refer the same to the Company Law Board with a request that the Company Law Board may inquire into the case and record a decision as to whether or not such person is a fit and proper person to hold a office of director or any other office connected with the conduct and management of any company.

· At the conclusion of the hearing of the case, the Company Law Board shall record its decision stating therein specifically as to whether or not the respondent is a fit and proper person to hold the office of director or any other office connected with the conduct and management of any company.

· The Central Government shall, by order, remove from office any director, or any other person concerned in the conduct and management of the affairs, of a company, against whom there is a decision of the Company Law Board as above.

[20] Section 33 of SICA.
[21] Sections 388B, 388D & 388E Companies Act 1956

2. Reduction in membership[22]

· 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 6 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 the payment of the whole debts of the company contracted during that time. Purpose of the provision being withdrawal of the advantages of incorporation when the conditions of incorporation are not maintained.

3. Misdescription of name[23]

· In any contract of a company, its name is not properly indicated; those who have done the act or made the contract shall be personally liable for it.

4. Holding and subsidiary Companies[24]

A company qualifies as a holding company when it has the power to control the composition of the board of directors of another company or holds a majority of its shares. It has been seen that a subsidiary company, even if it's a 100% one is a separate legal entity and its creator and controller is not to be held liable for its acts merely because he is the creator and controller, nor is the subsidiary to be held as an asset of the holding company. A subsidiary company may lose its separate identity to a certain extent for example when the legislature brushes aside legal forma and requires the companies in a group to present a joint picture or the court may just refuse to grant a subsidiary company an independent status. Thus it is clear that incorporation does not cut off personal liability at all times and in all circumstances. Those who reap the benefits of the machinery of incorporation have to assure a capital structure adequate to the size of the enterprise. They must not withdraw the corporate assets or mingle their own individual accounts with those of the corporation or represent to third parties that no difference exists between themselves and the company. The courts have at times seized upon these facts as evidence to justify the imposition of liability upon the shareholders.

5. Fiduciary obligation & Common law duties owed to the company

· It is one of the duties of directors to see 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.

· Directorships are always susceptible to abuse. The law therefore seeks to reduce the chances of abuse by making them liable for the acts committed.

[22] Section 45 Companies Act 1956
[23] Section 147 Companies Act 1956
[24] Section 4 Companies Act 1956

- ***Liability for breach of trust*** - the directors are in a fiduciary position, thus to act with honesty is asked for and therefore an undeserved gain would make the director personally liable.

- ***Directors' personal profits*** - Such profits are to accounted for if there is a slight doubt as to the credibility of the profits gained.

- ***Business opportunities*** - A director should not exploit to his own use the corporate opportunities. When a director is instructed to purchase some property for the company, and he purchases for the same himself and then sells it to the company at a profit, he is clearly liable to account for the profit so made.

- ***Director making personal use of company's opportunities*** - In certain cases a director may profit by a corporate opportunity without incurring the liability to account for it.

- ***Directorship when ceases to exist*** - Fiduciary obligation does not cease with resignation, but on the company exercising its right on full information to accept the resignation or to terminate his services if it so wishes.

- ***Competition by directors*** - Accountability chases a director if he happens to use the company's assets for the benefit of a rival concern, which is inclusive of business connections, goodwill, trade assets and the list of customers.

- ***Trading in corporate control*** - Directors other than the chairman are in a fiduciary relationship to the company and liable to repay to it the profit they make on the shares.

- ***Statutory provisions relating to sale of controlling shares***[25] - There are legal provisions designed to catch any extra payment that may be received by directors in connection with transfer of the undertaking or property or shares of a company. The right to control the management of a company is a valuable asset and it is desirable that if any price is obtained for the sale of this right, the members in accordance with their rights should share the same. The control of a company may pass in several ways. The scope of the words, ''Compensation for loss of office" and " consideration for retirement " is considerably widened by the applicable provision so that directors may not avoid their obligation to account by apparently separating the transfer of control from payment. Section 321 of Act, 1956 provides that any payment made by the transferee in pursuance of any arrangement entered into as a part of the agreement for transfer of shares, or within a year before or two years after the agreement, shall be deemed to have been received as "compensation for loss of office" or "consideration for retirement" and liable to be accounted for. Similarly, if the price paid to a retiring director for his shares in the company is in excess of the price pad to other shareholders or any other valuable consideration has been given to him, it shall also be regarded as "compensation" or "consideration" and must be disclosed to the shareholders.

[25] Sections 319-321 Companies Act 1956

- ***Misuse of corporate information*** - Using and exploiting unpublished and confidential information belonging to the company is a breach of duty and the company can ask the director in question to make good its loss, if any.

- The ***Securities and Exchange Board of India*** has formulated Regulations for preventing and punishing the use of price sensitive unpublished inside information in dealings with the company's securities.

- A Director has a duty of care and skill and is liable for negligence. However, there are provisions, which extend special protection against a liability that may have been incurred in good faith. It declares that in a criminal proceeding under the section the court shall have no power to grant relief from any civil liability.[26] Generally a director has to perform his functions personally. He would be liable for co-directors' default.

- ***Position and liability of a nominee director*** - A nominee director is not supposed to be in charge of a company's affairs. He is not liable for the failures of the company to comply with the companies Act and other regulatory laws. A nominee director suffers from an essential conflict of duty and interest. He owes his duty to the nominator but he is sitting in the board of the denominator. Problems never arise as long as the interests of companies are in harmony. But when the interests are at a conflict, the nominees are placed in a precarious situation.

- ***De Facto Directors*** - Directors include situations in which a person has acted as a director even though not validly appointed as one. To regard a person as a de facto director there must be conclusive evidence that he was the sole person directing the affairs of the company or that he acted on equal footing with other directors in managing the affairs of the Company. On disqualifying a director the Court has to have regard to his conduct as a director even though he had not been validly appointed.

- ***Prohibition of Assignment***[27] - Under Section 312 a director cannot assign his office in favour of anyone else. Any such assignment is void. In ***Oriental Metal Pressing Works Ltd V Bhaskar Kashinath Thakoor***, the Supreme Court has distinguished "assignment " from "nomination" as well as from "appointment."

- A vacancy by resignation, death or expiry of the term of his office, here will be nothing illegal if the power is exercised in the case of the death of the director, by an appointment of his will.

6. Disqualification of a Managing Director[28]

- No company can appoint or employ, or continue the appointment or employment of, any person as its managing or whole-time director who is an undercharged insolvent, or has at any time been adjudged an insolvent; suspends, or has at any time suspended, payment to his creditors, or makes, or has at any time made, a

[26] Section 633 Companies Act 1956
[27] Section 312 Companies Act 1956
[28] Section 267 Companies Act 1956

composition with them; or is, or has at any time been, convicted by a Court of an offence involving moral turpitude.

7. Disqualification of a Director[29]

· A person shall not be capable of being appointed director of a company, if he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force; he is an undischarged insolvent; he has applied to be adjudicated as an insolvent and his application is pending; he has been convicted by a Court of any offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months, and a period of five years has not elapsed from the date of expiry of the sentence; he has not paid any call in respect of shares of the company held by him, whether alone or jointly with others, and six months have elapsed from the last day fixed for the payment of the call; or an order disqualifying him for appointment as director has been passed by a Court.

8. Validity of acts of Directors[30]

· Acts done by a person as a director shall be valid, notwithstanding that it may afterwards be discovered that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in this Act or in the articles. Nothing herein shall be deemed to give validity to acts done by a director after his appointment has been shown to the company to be invalid or to have terminated.

9. Restrictions on the powers of Board[31]

· The Board of directors of a public company, or of a private company which is a subsidiary of a public company, shall not, except with the consent of such public company or subsidiary in general meeting, -

(a) sell, lease or otherwise dispose of the whole, or substantially the whole, of the undertaking of the company, or where the company owns more than one undertaking, of the whole, or substantially the whole, of any such undertaking;

(b) remit, or give time for the repayment of, any debt due by a director except in the case of renewal or continuance of an advance made by a banking company to its director in the ordinary course of business;

(c) invest, otherwise than in trust securities, the amount of compensation received by the company in respect of the compulsory acquisition, of any such undertaking as is referred to in clause (a), or of any premises or properties used for any such undertaking and without which it cannot be carried on or can be carried on only with difficulty or only after a considerable time;

[29] Section 274 Companies Act 1956
[30] Section 290 Companies Act 1956
[31] Section 293 Companies Act 1956

(d) borrow moneys, where the moneys to be borrowed, together with the moneys already borrowed by the company (apart from temporary loans obtained from the company's bankers in the ordinary course of business), will exceed the aggregate of the paid-up capital of the company and its free reserves, that is to say, reserves not set apart for any specific purpose; or

(e) contribute, to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed fifty thousand rupees or five per cent of its average net profits during the three financial years immediately preceding, whichever is greater.

10. Direct Tax Liability

· Persons, in charge of or responsible to the conduct of business at the time of contravention and acts done with consent or convenience or attributable to the neglect, shall be liable. He shall also be liable where he failed to exercise due diligence. Income Tax Act further provides that director may be treated as "assuree in default" where he failed to deduct the tax at source as provided in the act, provided he was in charge or accountable for such payment. In case of defaults tax would be recoverable from him.

11. Indirect Tax Liability

· It has also adopted the same principals for fixing liability for committing of an offence as laid down in the Income Tax Act.

12. Directors' liability towards workmen

· [32]The liability of Directors has been fixed, which provides that designated "occupier" (a Director only) shall be responsible for any offence caused as per the provisions of Companies Act. In absence of Occupier, all Directors are liable for such offence who were in charge of or responsible to the conduct of business of the company at the time of contravention or violation of law or with whose connivance or knowledge such offence was committed or fail to take steps for due diligence or commission of offence was attributable to the neglect of the directors. Recently Supreme Court has held that all Directors are responsible for commission of offence under the Factories Act if Occupier has not been appointed. It is further clarified that the Occupier must be a Director of the Board and not otherwise.

[33]A criteria for fixing the liability of the Directors is laid down as follows:

(i) Persons who were in charge of and responsible to conduct the business of the company at the time of such contravention or commission of offence.

(ii) The offence was committed with connivance and knowledge of person

[32] Section 93 FA 1948
[33] Shop & Estd. Act

(iii) Commission of offence is attributable to the neglect of the person/Director responsible for such breach.

(iv) Where person failed to exercise due diligence.

13. Civil Liability

. Civil laws have also adopted general principle for fixing of criminal liability on the directors for violation of any statutory provision or commission of offence. The criteria under important civil legislation, civil statute is given below: [34]**Dishonour of Cheques:** (a) every person who, at the time of offence, was in charge of, and was responsible to, the Company is responsible for the conduct of business, (b) offence was committed with his consent or connivance, (c) commission of offence attributed any negotiation on his part and (d) he failed to exercise all due diligence to prevent the commission of such offence.

Directors who have signed the cheques and loan agreements are liable for commission of offence for dishonor of cheques[4]. The Court has decided that a specific allegation relating to commissioning of offence must be levelled in the complaint file before the Court together with required evidences. If complainant failed to comply these obligations, directors cannot be held liable for dishonour of cheques.

The above criteria have been adopted in respect of Electricity laws and Municipal laws.

14. Liability under fiscal laws

In respect of **Foreign Exchange Management Act, 1999,** Section 42 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence. **Monopolies & Restrictive Trade Practices Act, 1971,** Section 53 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person in charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence committed by the company. **Securities Contract Regulation Act,** Section 24 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person in charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence. **Security Exchange Board of India Act, 1993,** Section 27 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person in charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence. **Depositories Act,** Section 21 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the

[34] Section 141 Negotiable Instruments Act

company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence.

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?

Introduction:

In order to understand and ascertain the liabilities of persons other than the directors, it is not only desirable but also imperative to find out as to who are these `other persons' or in other words who all form part of the said expression `other persons'. We have identified the following as being `other persons'.

Firstly,"manger" of a company means an individual (not being the managing agent) who, subject to the superintendence, control and direction of the Board of directors, has the management of the whole, or substantially the whole, of the affairs of a company and includes a director or any other person occupying the position of a manger, by whatever name called, and whether under a contract of service or not.[35] Secondly, "managing agent" means any individual, firm or body corporate entitled, to the management of the whole, or substantially the whole of the affairs of a company by virtue of an agreement with the company, or by virtue of its memorandum or articles of association and includes any individual, firm or body corporate occupying the position of a managing agent, by whatever name called.[36]

Most importantly, an "officer" includes any director, managing agent, secretaries and treasurers, manager or secretary; where the managing agent or the secretaries and treasurers are a firm, also includes any partner in the firm; and where the managing agent or the secretaries and treasurers are a body corporate, also includes any director, managing agent, secretaries and treasurers or manager of the body corporate.[37]

[35] Section 2(24) 1956 ACT
[36] Section 2(25) 1956 ACT
[37] Section 2(30) 1956 ACT

Further, "secretaries and treasurers" means any firm or body corporate (not being the managing agent) which, subject to the superintendence, control and direction of the Board of directors, has the management of the whole or substantially the whole, of the affairs of a company; and includes any firm or body corporate occupying the position of securities and treasurers, by whatever name called, and whether under a contract of service or not.[38] "Secretary" means the person, if any, who is appointed to perform the duty, which may be performed by a secretary.[39]

An officer of the company (regardless of whether he is a director or not) who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression "officer who is in default" means any officer of the company who is knowingly guilty of the default, non-compliance, failure, refusal or contravention mentioned in that provision, or who knowingly and wilfully authorises or permits such default, non-compliance, failure, refusal or contravention.[40] In the present context, it is also important to note as to who is a "contributory" during the winding up proceedings, “contributor” means every person liable to contribute to the assets of a company in the event of its being wound up and includes the holder of any shares which are fully paid up; and for the purposes of all proceedings for determining, and all proceedings prior to the final determination of, the persons who are to be deemed contributories, includes any person alleged to be a contributory.[41]

Hence, even other persons are liable during `twilight period’ in addition to the directors. However, before we start off with the nature of liabilities of these other persons, let us discuss the general principle underlining the liability of the members of the company viz. its winding up and i.e.

- Liability as Contributories of present and past Members[42]

  (a) 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 to an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of the winding up, and for the adjustment of the rights of the contributories among themselves.

  (b) a past member shall not be liable to contribute if he has ceased to be a member for one year or upwards before the commencement of the winding up.

  (c) a past member shall not be liable to contribute in respect of any debt or liability of the company contracted after he ceased to be a member.

  (d) no past member shall be liable to contribute unless it appears to the Court that the present members are unable to satisfy the contributions required to be made by them.

[38] Section 2(44) 1956 ACT
[39] Section 2(45) 1956 ACT
[40] Section 5 1956 ACT
[41] Section 428 1956 ACT
[42] Section 426 1956 ACT

(e) in the case of a company limited by shares, no contribution shall be required from any past or present member exceeding the amount, if any, unpaid on the shares in respect of which he is liable as such member.

(f) in the case of a company limited by guarantee, no contribution shall be required from any past or present member exceeding the amount undertaken to be contributed by him to the assets of the company in the event of its being wound up. In the winding up of a company limited by guarantee which has a share capital, every member of the company shall be liable, in addition to the amount undertaken to contributed by him to the assets of the company in the event of its being wound up, to contribute to the extent of any sums unpaid on any shares held by him as if the company were a company limited by shares.

(g) **Insurance Aspect:** By virtue of any of the provisions pertaining to winding up or otherwise, there shall not be any sort of invalidation of any policy of insurance or other contract whereby the liability of individual members on the policy or contract is restricted, or whereby the funds of the company are alone made liable in respect of the policy or contract.

(h) Further, a sum due to any past or present member of the company in his character as such, by way of dividends, profits or otherwise, shall not be deemed to be a debt of the company payable to that member, in a case of competition between himself and any creditor claiming otherwise than in the character of a past or present member of the company; but any such sum shall be taken into account for the purpose of the final adjustment of the rights of the contributors among themselves.

1. Misconduct By Officers of Companies in Liquidation[43]

1.1 A past or present officer of a company commits an offence if he -

(a) does not, to the best of his knowledge and belief, fully and truly discover to the Liquidator all the property, movable and immovable, of the company, 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 the business of the company;

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

(c) does not deliver up to the Liquidator, or as he directs, all such books and papers of the company as are in his custody or under his control and which he is required by law to deliver up;

(d) within the 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 one hundred rupees or upwards, or conceals any debt due to or from the company;

[43] Section 538 1956 ACT

(e) within the 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 one hundred rupees or upwards;

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

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

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

(i) within the twelve months 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;

(j) within the 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;

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

(l) after the commencement of the winding up or at any meeting of the creditors of the company within the twelve months 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;

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

(n) within the twelve months next before the commencement of the winding up or at any time thereafter, under the 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;

(o) within the 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 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;

1.3 If any of the above from (a)-(p) are satisfied:

(i) The liability under this provision is criminal.

(ii) A person guilty of this offence is liable to imprisonment or a fine or both.

(iii) The gravity of the misconduct is demonstrable from the term of imprisonment or the extent of the fine that is imposed. In exercising its punitive jurisdiction, the court(s) hereunder do not seek to compensate the company concerned. The officer shall be punishable, in the case of any of the offences above mentioned in sub-paras (m), (n) and (o), with imprisonment for a term which may extend to five years, or with fine, or with both, and, in the case of any other offence, with imprisonment for a term which may extend to two years, or with fine, or with both;

(iv) As can be gathered from the above that certain acts of the officers even if having been committed within 12 months immediately preceding the commencement of the winding up proceedings could constitute offences of misconduct, hence during twilight period.

(v) It shall be a good defence -

(vi) to a charge under any of the above mentioned sub-paras (b), (c), (d), (f), (n) and (o), if the accused proves that he had no intent to defraud; and

(vii) to a charge under any of the above mentioned sub-paras (a), (h), (i) and (j), if he proves that he had no intent to conceal the true state of affairs of the company or to defeat the law.

2. Defrauding of Creditors[44]

2.1 The offence is committed by an officer of a company which is subsequently ordered to be wound up by the Court or which subsequently passes a resolution for voluntary winding up, if he –

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

(b) with intent to defraud creditors of the company, 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 judgement or order for payment of money obtained against the company, or within two months before that date;

[44] Section 540 1956 ACT

2.2 (i) The liability under this provision is criminal. Hence, the answers to (ii) and (iii) are as set out in para 1.2 above, subject to, however that in the present case the guilty officer shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine.

(ii) There is no hard and fast rule as to maximum gap between the impugned transaction and the order of winding up by the Court or passage of a resolution for voluntary winding up. It all depends on the evidence to be adduced so as to prove that when the transaction took place, it was within the knowledge of the officer that the company was bound or likely to go in for liquidation.

(iii) Absence of mens rea i.e. absence of intention to defraud is the available defence.

3. Maintenance of Improper Accounts[45]

3.1 (i) 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 guilty of the offence under this provision.

(ii) It shall be deemed that proper books of account have not been kept in the case of any company, if there have not been kept –

(a) such books or accounts as are necessary to exhibit and explain the transactions and financial position of the business of the company, including books containing entries made from day to day in sufficient detail of all cash received and all cash paid; and

(b) where the business of the company has involved dealings in goods, statements of the annual stock takings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

3.2 (i) The liability under this provision is criminal. Hence, the answers to (ii) and (iii) are as set out in para 1.2 above, subject to, however that in the present case the guilty officer shall be punishable with imprisonment for a term which may extend to one year.

(ii) The offence must have been committed throughout the period of 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.

(iii) The defence available to the officer is to show that he acted honestly and that in the circumstances in which the business of the company was carried on, the default was excusable.

[45] Section 541 1956 Act

4. Falsification of Company's Books[46]

4.1 An offence under this provision is committed, if any officer or contributory of a company, which is being wound up, with intent to defraud or deceive any person,

(a) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

(b) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company.

4.2 (i) The liability under this provision is criminal. Hence, the answers to (ii) and (iii) are as set out in para 1.2 above, subject to, however that in the present case the guilty officer shall be punishable with imprisonment for a term which may extend to seven years and shall also be liable to fine.

(ii) This offence applies when the company is being wound up.

(iii) Absence of mens rea i.e. absence of intention to defraud or deceive any person by virtue of commission of the above acts is the available defence.

5. Fraudulent Conduct of Company's Business[47]

5.1 The 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 persons, or for any fraudulent purpose. The 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.

5.2 This applies where a company is being wound up and it is shown that the business of the company as 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:

- there has to be an insolvent liquidation in progress;
- here has to have been dishonesty in the running of the business as that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose;
- as dishonesty is involved, the standard of proof is that of 'beyond reasonable doubt', even in a case of civil liability;
- it applies to persons who are "knowingly parties" to the fraudulent trading which may be both wider and narrower than the concept of director/shadow director for wrongful trading, but it could in theory, be wide enough to catch a

[46] Section 539 1956 Act
[47] Section 542 1956 Act

financier who funded the fraudulent trading knowing that it was being done dishonestly.

5.3 (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 but it may also include a punitive element in the award of damages made.

(iii) As indicated in (ii) above, there should be an element of proportionality albeit that the court's discretion is very wide.

(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.

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.

6. Delinquency, Breach of Trust & Misfeasance: Directors and others [48]

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;

6.2 (i) The liability under this provision is civil.

(ii) A person guilty of this offence can be compelled by the Court to repay or restore the money or property or any part thereof respectively, 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, as the Court thinks just.

(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) The proceeding can be instituted under this provision within five years from the date of the order for winding up, or of the first appointment of the

[48] Section 543 1956 Act

Liquidator in the winding up, or of the misapplication, retainer, misfeasance or breach of trust, as the case may be, whichever is longer.

(v) There is a defence where the director has acted honestly and reasonably and the court concludes that he ought fairly to be excused.

7. Misfeasance Proceedings[49]

7.1 An offence is made out, if, in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal, it appears to the Board for Industrial and Financial Reconstruction any person who has taken part in the promotion, formation or management the sick industrial company or its undertaking, including any past or present director, manager or officer or employee of the sick industrial company-

(a) has misapplied or retained, or become liable or accountable for, any money or property of the sick industrial company; or

(b) has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust in relation to the sick industrial company,

7.2 (i) The liability under this provision is civil.

(ii) A person guilty of this offence can be directed 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 sick industrial company or the other person, entitled thereto by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Tribunal thinks just and also report the matter to the Central Government for any other action which that Government may deem fit. Further, 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 industrial 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 a bona fide purpose 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, during a 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).

(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.

(vi) The proceeding can be instituted under this provision in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal of a sick company by the Tribunal.

[49] Section 24 SICA

(vii) There is a defence where the director has acted honestly and reasonably and the court concludes that he ought fairly to be excused.

8. Directors and Managers with unlimited liability[50]

8.1 In the winding up of a limited company, any director, or manager, whether past or present, whose liability is, under the provisions of this Act, unlimited, shall, in addition to his liability, if any, to contribute as an ordinary member, be liable to make a further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.

Exceptions:

(a) a past director or manager shall not be liable to make such further contribution, if he has ceased to hold office for a year or upwards before the commencement of the winding up;

(b) a past director, or manger 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;

(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.

9. Removal of Managerial Personnel[51]

· Where in the opinion of the Central Government there are circumstances suggesting that any person concerned in the conduct and management of the affairs of a company is or has been in connection therewith guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations and functions under the law, or breach of trust; or that the business of a company is not or has not been conducted and managed by such person accordance with sound business principles and prudent commercial practices; or that a company is or has been conducted and managed by such person in a manner which is likely to cause, or has caused, serious injury or damaged to the interest of the trade, industry or business to which such company pertains; or that the business of the company is or has been conducted and managed by such person with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest, the Central Government may state a case against the person aforesaid and refer the same to the Company Law Board with a request that the Company Law Board may inquire into the case and record a decision as to whether or not such person is a fit and proper person to hold a office of director or any other office connected with the conduct and management of any company.

[50] Section 427 1956 Act
[51] Sections 388B, 388D & 388E 1956 Act

- At the conclusion of the hearing of the case, the Company Law Board shall record its decision stating therein specifically as to whether or not the respondent is a fit and proper person to hold the office of director or any other office connected with the conduct and management of any company.

- The Central Government shall, by order, remove from office any director, or any other person concerned in the conduct and management of the affairs, of a company, against whom there is a decision of the Company Law Board as above.

10. Reduction in membership[52]

- 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 6 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 the payment of the whole debts of the company contracted during that time. Purpose of the provision being withdrawal of the advantages of incorporation when the conditions of incorporation are not maintained.

11. Misdescription of name[53]

- In any contract of a company, its name is not properly indicated; any of those persons who have done the act or made the contract shall be personally liable for it.

12. Holding and subsidiary Companies[54]

A company qualifies as a holding company when it has the power to control the composition of the board of directors of another company or holds a majority of its shares. It has been seen that a subsidiary company, even if it's a 100% one is a separate legal entity and its creator and controller is not to be held liable for its acts merely because he is the creator and controller, nor is the subsidiary to be held as an asset of the holding company. A subsidiary company may lose its separate identity to a certain extent for example when the legislature brushes aside legal form and requires the companies in a group to present a joint picture or the court may just refuse to grant a subsidiary company an independent status. Thus it is clear that incorporation does not cut off personal liability at all times and in all circumstances. Those who reap the benefits of the machinery of incorporation have to assure a capital structure adequate to the size of the enterprise. They must not withdraw the corporate assets or mingle their own individual accounts with those of the corporation or represent to third parties that no difference exists between themselves and the company. The courts have at times seized upon these facts as evidence to justify the imposition of liability upon the shareholders.

[52] Section 45 1956 Act
[53] Section 147 1956 Act
[54] Section 4 1956 Act

13. Direct Tax Liability

· Persons, in charge of or responsible to the conduct of business at the time of contravention and acts done with consent or convenience or attributable to the neglect, shall be liable. He shall also be liable where he failed to exercise due diligence. Income Tax Act further provides that director may be treated as "assuree in default" where he failed to deduct the tax at source as provided in the act, provided he was in charge or accountable for such payment. In case of defaults tax would be recoverable from him.

14. Indirect Tax Liability

· It has also adopted the same principals for fixing liability for committing of an offence as laid down in the Income Tax Act.

15. Liability under fiscal laws

Officers in management and directors have been treated at par with each other hereunder. In respect of **Foreign Exchange Management Act, 1999,** Section 42 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence. **Monopolies & Restrictive Trade Practices Act, 1971,** Section 53 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence committed by the company. **Securities Contract Regulation Act,** Section 24 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence. **Security Exchange Board of India Act, 1993,** Section 27 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence. **Depositories Act,** Section 21 of the Act adopted the identical criteria for fixing the liability of officers / directors of the company for offences committed by the company. However, the Act provides the person In charge of or responsible to the affairs of the company shall be deemed to be guilty for commission of offence.

The position otherwise is similar to what exists under the English Law.

QUESTION 4

4. Counterparties dealing with the company during the twilight period

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

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

1. Introduction

Like it is the case in most of the legal systems, in India too, the legal position is such that seeks to undo transactions prejudicial to a company and/or are unfairly beneficial to a counterparty, particularly when they are entered into during the twilight period.

2. Summary of heads of challenge

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

(i) which are at an undervalue;
(ii) which are preferences;
(iii) defrauding creditors;
(iv) which constitute extortionate credit bargains;
(v) comprising floating charges given for past value;
(vi) in breach of the directors' fiduciary duties;
(vii) involving onerous property;
(viii) dispositions of the company's property made after the commencement of winding-up;
(ix) unregistered charges.

3. Transactions at an undervalue

An undervalued transaction 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. Of course, the sale should have been made during the twilight period.

Defences

The court may not make set aside an undervalued transaction if it is satisfied that the company which entered into the transaction did so 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 certain purchasers in good faith and for value.

4. Preferences

A preference transaction is also not defined. It is an act of putting a creditor in a better position than he would have been if the company had instead just gone into liquidation. If it is questioned, the court has a range of options to restore the position.

Conditions for setting aside a 'preference'

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:

Defences

There are very few reported examples of such transactions. However, it can be reasonably stated that 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 as is the case under English law. This is a question of fact and requires to be established by leading evidence.

5. Transactions defrauding creditors

Conditions

If an asset charged to a creditor or from which a creditor could later recover its dues is sold with intent to put the 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 can restore and protect the interests of the persons who are effected by the transaction.

Defences

Principles adopted are the same as in case of undervalued sale and preference sale.

6. Extortionate credit transactions

Conditions

The court can set aside or vary a transaction for, or involving, the provision of credit to the company. It is a matter of fact and evidence.

Defences

There are no statutory defences (other than successfully to disprove the allegation).

7. Avoidance of floating charges for past value[55]

7.1 (i) Where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to 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 on that amount at the rate of five percent per annum or such other rate as may for the time being be notified by the central Government in this behalf in the official Gazette. Provided that in relation to a charge created more than three months before the commencement of this Act, this section shall have effect with the substitution for references to twelve months of references to three months.

(ii) Payments of certain debts out of assets subject to floating charge in priority to claims under the charge- where either-

(a) a receiver is appointed on behalf of the holders of any debentures of a company secured by a floating charge, or

(b) possession is taken by or on behalf of those debenture holders of any property comprised in or subject to the charge; then, if the company is not at the time in course of being wound up, the debts which in every winding up are, under the provisions of Part VII of the Companies Act, 1956 relating to preferential payments, to be paid in priority to all other debts, shall be paid out of any assets coming to the hands of the receiver or other person taking possession as aforesaid in priority to any claim for principal or interest in respect of the debentures.

(iii) In the application of the provisions mentioned above, Section 530 shall be construed as if the provision for payment of accrued holiday remuneration becoming payable on the termination of employment before or by the effect of the winding up order or resolution were a provision for payment of such remuneration becoming payable on the termination of employment before or by the effect of the appointment of the receiver or possession being taken as aforesaid.

[55] Section 534 of 1956 Act.

(iv) The periods of time mentioned in the said provisions shall be taken from the date of appointment of the receiver or of possession being taken as aforesaid, as the case maybe.

8. Breach by Directors of general / common law duties

If the Directors commit acts, which place the company in a precarious situation, they may be in breach of certain common law duties they owe to the company. Some of these duties are being repeated here and have already been mentioned under question two.

Common law duties owed to the company

- It is one of the duties of directors to see 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.

- Directorships are always susceptible to abuse. The law therefore seeks to reduce the chances of abuse by making them liable for the acts committed.

- ***Liability for breach of trust*** - the directors are in a fiduciary position, thus to act with honest is asked for and therefore an undeserved gain would make the director personally liable.

- ***Directors' personal profits*** - Such profits are to accounted for if there is a slight doubt as to the credibility of the profits gained.

- ***Business opportunities*** - A director should not exploit to his own use the corporate opportunities. When a director is instructed to purchase some property for the company, and he purchases for the same himself and then sells it to the company at a profit, he is clearly liable to account for the profit so made.

- ***Director making personal use of company's opportunities*** - In certain cases a director may profit by a corporate opportunity without incurring the liability to account for it.

- ***Directorship when ceases to exist*** - Fiduciary obligation does not cease with resignation, but on the company exercising its right on full information to accept the resignation or to terminate his services if it so wishes.

- ***Competition by directors*** - Accountability chases a director if he happens to use the company's assets for the benefit of a rival concern, which is inclusive of business connections, goodwill, trade assets and the list of customers.

- ***Trading in corporate control*** - Directors other than the chairman are in a fiduciary relationship to the company and liable to repay to it the profit they make on the shares.

- ***Statutory provisions relating to sale of controlling shares***[56] - There are legal provisions designed to catch any extra payment that may be received by directors in connection with transfer of the undertaking or property or shares of a company. The right to control the management of a company is a valuable asset and it is desirable that if any price is obtained for the sale of this right, the members in accordance with their rights should share the same. The control of a company may pass in several ways. The scope of the words, ‘‘Compensation for loss of office” and “ consideration for retirement “ is considerably widened by the applicable provision so that directors may not avoid their obligation to account by apparently separating the transfer of control from payment. Section 321 of Act, 1956 provides that any payment made by the transferee in pursuance of any arrangement entered into as a part of the agreement for transfer of shares, or within a year before or two years after the agreement, shall be deemed to have been received as “compensation for loss of office” or “consideration for retirement” and liable to be accounted for. Similarly, if the price paid to a retiring director for his shares in the company is in excess of the price pad to other shareholders or any other valuable consideration has been given to him, it shall also be regarded as “compensation” or “consideration” and must be disclosed to the shareholders.

- ***Misuse of corporate information-***Using and exploiting unpublished and confidential information belonging to the company is a breach of duty and the company can ask the director in question to make good its loss, if any.

9. Disclaimer of onerous property

9.1 The Liquidator may abandon onerous properties belonging to the company. The following properties are regarded as onerous [57]-

(a) land of any tenure, burdened with covenants;

(b) shares or stock in companies

(c) any other property which is unsaleable or is not readily saleable by reason of the fact that it requires the possessor to perform certain acts or pay a sum of money.

(d) Unprofitable contracts.

9.2 The Liquidator may with leave of the court disclaim any such property and it’s the duty of the court to help the Liquidator to get rid of onerous contracts whenever it is necessary to safeguard in full the interests of the body of creditors and the shareholders of the company.

The disclaimer should be in writing signed by the Liquidator. It has to be made within 12 months after the commencement of 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 thus releases the company and property from liability.

[56] Sections 319-321 1956 Act.
[57] Section 535 of 1956 Act.

10. 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[58] –

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 leave of the court, of any of the properties or effects of the company after such commencement; shall be void.

11. Failure to register a charge

11.1 The power to borrow includes the power to mortgage the company's assets or to create a charge upon them as lenders always insist on some security and the only security that a company can give is to charge its 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.

1. a charge for the purpose of securing any issue of debentures;
2. a charge on uncalled share capital of the company;
3. a charge on any immovable property, wherever situate or any interest therein;
4. a charge on any book debts of the company;
5. a charge , not being a pledge, on any moveable property of the company;
6. a floating charge on the undertaking or any property of the company including stock in trade;
7. a charge on calls made, but not paid;
8. a charge on a ship or any share in a ship;
9. 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.

11.2 The Registrar has to issue a certificate under his hand of the registration of any charges stating the amounts secured. The certificate hence becomes conclusive evidence that the requirements as to registration have been complied with. Registration must be effected within thirty days of the creation of the charge. Extension of time is upto the discretion of the Registrar.

11.3 The advantage of registration is that the charge becomes binding on the company even in its winding up and also on every subsequent purchaser or incumbracer of the property covered by the charge. The effect of non-registration is that the charge would be void against the Liquidator and any creditor of the company.

[58] Section 537 of 1956 Act.

QUESTION 5

5. Enforcement

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

Introduction

When a company goes into liquidation, the authority and powers of the directors are take 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 in essence is empowered to bring actions against the directors and others where there has been a breach of either legal or fiduciary duties owed to the company subject to the authority of the Court without the sanction of which these proceedings would have no effect.

Criminal Proceedings

The following acts are criminal offences which the Official Liquidator is duty bound to bring to the Court's notice

Offences

Fraudulent removal or concealment of property to prevent distribution among creditors Falsification of accounts- these are punishable under the Indian Penal Code and hence for implicating the offenders, the offences have to be brought to notice of the Court in order to take appropriate legal action.

(i) Falsification of company's books - section 539

(ii) Fraud by officers- section 540

(iii) Offences by officers-section 538

(iv) Fraudulent conduct of business-section 542

(v) Wrongful withholding of property-section 630

(vi) False representations to creditors –section 538 (m)

(vii) Disqualification of a director-section 274

The Sections referred above are of Companies Act, 1956.

Civil Proceedings

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, a provision thereby providing access of a range of people to bring action to recover funds for the benefit of the company's creditors. The overall recovery so made is distributed evenly amongst the creditors in accordance to the rules relating to priority. The table below sets out those people who may bring an action against the directors and others in connection with certain transactions, which the company has entered into.

Activity/transaction	**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

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	Penalty is up to 5years and/or fine in case of falsely representing/pledging/pawning/disposal of company's property by obtaining credit for himself. For others penalty is up to two years imprisonment an/or fine.
Misconduct in winding up	A person guilty of this offence is liable to imprisonment or a fine or both.
Falsification of Company Books	Penalty is up to seven years' imprisonment and/or a fine.
False representations to creditors	Punishment with imprisonment for a term, which may extend to two years and fine.
Misfeasance	A person guilty of this offence can be compelled by the Court to repay or restore the money or property or any part thereof respectively, 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, as the Court thinks just.
Fiduciary Duties	Liability is civil. The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.
Duties of skill and care	Liability is civil. The director may be ordered to compensate the company for all and damage caused by breach of his fiduciary duty.
Fraudulent conduct of business	Penalty is up to two years imprisonment and /or fine.
Fraud by officers	Penalty is up to two years imprisonment and/ or fine.
Destroying, mutilating company documents including making an omission in a document	Liability is criminal. Penalty may be up to a term which may extend to two years, or with fine, or with both;
Conduct rendering a director unfit to be a director	Liability is civil.

Transactions at an undervalue and preferences	There is no specific remedy provided under the 1956 Act and/or SICA unless transaction at an undervalue and preference is treated as an offence under Section 24 of SICA and Section 543 of 1956 Act (as detailed reply to Question No. 2) and it could be ordered that adequate money be contributed by way of compensation to make good the difference. Such a direction can come 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.
Transactions defrauding creditors	Liability is criminal as well as civil. Action for Criminal Breach of Trust can be brought if the transaction involved a property charged to creditors. Civil action can also be brought for e.g. If Dividend is paid to shareholders but creditors are not paid despite an agreement to this effect, creditors can bring an action.
Extortionate Credit Transactions	Liability is civil. Civil action for setting aside such transactions can be brought.
Avoidance of a floating charge	Liability is civil. The Court can declare that the floating charge is invalid in whole or in part.

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)?

1. Obligation to co-operate with investigation into company's affairs

1.1 *General duty to co-operate*

(i) Under the 1956 Act and SICA there is no specific provision, which exclusively makes certain people duty bound to cooperate with investigation into Company's affairs. However, such duty is implicit in various other provisions,

which makes it obligatory to co-operate. Under SICA, BIFR/AAIFR are empowered to seek information. Under 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 reasonably require; and to attend on the BIFR/AAIFR official Liquidator at such times as they may reasonably require.

1.2 It applies in the case of a company where:

(a) Proceedings are pending before BIFR/AAIFR under SICA though this is an investigation prior to the recommendation of winding up of the company.

(b) A winding up petition has been presented

(c) a Provisional or an Official Liquidator has been appointed; or

(d) the company goes into liquidation; or

(e) a winding-up order has been made by the court.

1.3 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 official Liquidators 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 official Liquidator or provisional Liquidator of the company.

1.4 *Sanction*

If a person without reasonable excuse fails to comply with any obligation imposed he is liable to a fine or even contempt of court or guilty of offence under Section 33 of SICA.

2. Obligation to assist with getting in the company's property[59]

2.1 This obligation is cast in the case of a company where:

(a) a winding up order has been made; or

(b) a Provisional Liquidator or Official Liquidator has been appointed; or

(c) the company goes into liquidation.

And if any of the situations in (a), (b) or (c), the Liquidator or the provisional Liquidator shall take into custody or under his control, all the property, effects and actionable claims to which the company is or appears to be entitled.

2.2 *Sanction*

The court has the power to summon persons suspected of having property of the company and the court may require the person(s) to produce any books and papers in his custody relating to the company.[60] Failure to appear before the court may lead to his apprehension and be brought before the court for further examination.

3. Obligation to provide information [61]

3.1 The court may, summon to appear before it:

(a) any officer of the company;

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

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

This section has a very wide application.

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 and papers in his custody or under his control relating to the company but where he claims any lien on books or papers produced by him, the production shall be without prejudice to that lien and the court shall have jurisdiction in the winding up to determine all questions relating to that lien.

[59] Section 456 of 1956 Act.
[60] Section 477 of 1956 Act.
[61] Section 477 of 1956 Act.

3.2 *Sanctions*
If any officer or person so summoned, after being paid or tendered a reasonable sum for his expenses, fails to appear before the court at the appointed time, not having a lawful impediment, the court may cause him to be apprehended and brought before the court for examination.

4. Company's statement of affairs[62]

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 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 Liquidators 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.

4.2 *Sanction*

Past or present officers of the company may commit an offence if they make material omissions from the statement of affairs.

5. Public examination of officers[63]

5.1 Where a company is being wound up by the court, the official Liquidator has made a report to the court stating that in his opinion a fraud has been committed by any person (a) in the promotion or formation of the company or (b) by any officer of the company. Since its formation, the court may direct hat the person or officer may appear before the Court and be publicly examined.

5.2 *Sanction*

The court may on proof of probable cause for believing that a contributory is about to quit India or abscond, or avoid examination respecting affairs of the company have the contributory to be arrested and his books and papers and movable property to be seized and safely kept until such time as the court may order.[64]

[62] Section 454 of 1956 Act.
[63] Section 478 of 1956 Act.
[64] Section 479 of 1956 Act.

6. Human Rights

In India, Human Rights are sought to be protected under the Protection of Human Rights Act, 1993. The Act was enacted to take into account, gross violation of Human Rights, meaning rights related to life, liberty, equality and dignity of an individual guaranteed by the Constitution of India or embodied in the International Covenants and so enforceable in Indian Courts.

The Act provides for a National and State Level Commissions, which inquire *suo moto* or on a petition presented to it by a victim or any person on his behalf. These complaints are in the nature of violation of human rights or abetment and negligence in the prevention of such violation by a public servant.

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 production of any document
(c) receive evidence on affidavits
(d) requisition any public record or copy thereof from any court or office;
(e) issue commissions for the examination of witnesses or documents;
(f) and any other matter which may be prescribed

The Commission has the power of conducting any investigation pertaining to an inquiry, it can also call for information from the Government or any other Authority.

Opportunity

It gives reasonable opportunity to people who are likely to be adversely or prejudicially affected.

Incriminating Statement

Statements made by persons to the commission cannot be used against him in any civil or criminal proceeding except a prosecution for giving false evidence by such statement,

Action taken

If the inquiry discloses Human Rights violation or negligence on part of a public servant, appropriate steps are taken in the Court of law for punishing the accused as the law permits.

It is also important to note that proceedings in the Human Rights Court are deemed to be judicial proceedings.

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.

Limitation Period for Criminal Proceedings

1.1 The position is same as under English Law viz. the general rule being that no limitation period applies to criminal proceedings unless stipulated by statute. No limitations apply to the offences attracting criminal liability, which have been identified in the answer to Question No. 6. The disqualification proceedings can be initiated in civil proceedings.

Limitation Period for Civil Actions

Delinquency, Breach of Trust & Misfeasance: Directors and others[65]

1.2. An application under Section 543 of 1956 Act, which is similar to Section 24 of SICA has to be made within five years from the date of order of winding up or of the first appointment of the Liquidator or of the alleged offence whichever is longer. However, no limitation has been provided under SICA.

Other Offences[66]

1.2 For the other offences, no specific limitation has been provided. In such event, normally the courts go by the limitation provided under Limitation Act, 1963. As per the Limitation Act, in relation to any suit / application for which no period of limitation is provided elsewhere under the Limitation Act, 1963, the period of limitation is three years and the time from which the period begins to run is when the right to sue/ apply accrues

2. Appeals

2.1 (i) An Appeal against the order passed by 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.

[65] Section 543 of 1956 Act.
[66] Under 1956 Act & SICA.

(ii) Most of the complaints for offences committed under the 1956 Act lie before the Company Law Board. An appeal against the order of the Company Law Board lies to the Company Judge of the concerned High Court. within whose jurisdiction the company is located. The Company Law Board has the same power as that of a Civil Court. The Company Law Board has no power to review its order. The orders passed by Company Law Board are also subject to judicial review in extraordinary writ jurisdiction of 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 such order. There can be no appeal on a question of fact and hence the Board becomes the final authority so far as questions of fact are concerned. The time for filing appeals has been fixed to be 60 days, which are to be counted from the date of the communication of an order or decision to the appellant. The High Court has been empowered on sufficient cause to extend the time for a further period of 60 days. Its important to note that 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.

(iii) Actions brought before Civil Judge/Magistrate, the lowest court are appealable before District Judge. A revision also lies against the order of Civil Judge to the High Court if the order is questioned for want of jurisdiction. The order of District Judge can be challenged before the High Court. Under the scheme of the Indian Constitution, the orders of High Court are final and only if leave is granted, Appeal lies to Supreme Court of India.

QUESTION 9

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9. Foreign Corporations

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

· In the present context, the Provisions outlined above do not as such or en-block applies to the foreign companies but these apply with certain riders. These riders are part of those provisions, which are discussed, below, which apply to the foreign companies. With regard `twilight period', foreign companies can be treated as `unregistered companies' in India. However, needless to mention that a wholly owned subsidiary in India of a foreign company is not a foreign company but a domestic company to which all the provisions discussed in the preceding chapters shall apply.

· Before any discussion it is essential to know as to which foreign companies could be exposed to the provisions stated hereunder. These are those companies incorporated outside India, which establish a place of business within India. [67]

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[67] Section 591 CA 1956

1. Unregistered Company includes a foreign company[68]

1.1 Unregistered company shall include any company including any partnership, association or company consisting of more than seven members except 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 the registered office whereof was in Burma, Aden or Pakistan immediately before the separation of the country from India or in the State of Jammu and Kashmir immediately before the 26th January, 1950;

2. Winding up of unregistered companies[69]

2.1 Any unregistered company may be wound up and all the provisions as discussed in the preceding chapter with respect to winding up shall apply to an unregistered company.

2.2 For the purpose of determining the Court having jurisdiction in the matter of the winding up, an unregistered company shall be deemed to be registered in that State of India where its principal place of business is situate or, if it has a principal place of business situate in more than one State, then, in each State where it has a principal place of business; and the principal place of business situate in that State in which proceedings are being instituted shall for all the purposes of the winding up, be deemed to be the registered office of the company.

2.3 No unregistered company shall be wound up voluntarily or subject to the supervision of the Court.

2.4 [70]Where a body corporate incorporated outside India which has been carrying on business in India, ceases to carry on business in India, it may be wound up as an unregistered company notwithstanding that the body corporate has been dissolved or otherwise ceased to exist as such under or by virtue of the laws of the country under which it was incorporated.

3. Criteria of winding up[71]

3.1 If the company is dissolved, or has ceased to carry on business, or is carrying of business only for the purpose of winding up its affairs;

3.2 If the company is unable to pay its debts;

3.3 if the Court is of opinion that it is just and equitable that the company should be wound up.

3.4 An unregistered company shall be deemed to be unable to pay its debts —

[68] Section 582 CA 1956
[69] Section 583 CA 1956
[70] Section 584 CA 1956
[71] Section 583 CA 1956

(a) if a creditors, be assignment or otherwise, to whom the company is indebted in a sum exceeding five hundred rupees then due, has served on the company, by leaving at its principal place of business, or by delivering to the secretary, or some director, managing agent, secretaries and treasures manager or principal officer of the company, or by otherwise serving in such manner as the Court may approve or direct, 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) if any suit or other legal proceeding has been instituted against any member for any debt or demand due, or claimed to be due, for the company, or from him in his character of member, and notice in writing of the institution of the suit or other legal proceeding having been served on the company by leaving the same at its principal place of business or by delivering it to the secretary, or some director, managing agent, secretaries and treasurers, manager or principal officer of the company or by otherwise serving the same in such manner as the Court may or direct, the company has not, within ten days after service of the notice,—

(i) paid, secured or compounded for the debt or demand; or
(ii) procured the suit or other legal proceeding to be stayed; or
(iii) indemnified the defendant to his satisfaction against the suit or other legal proceeding, and against all costs, damages and expenses to be incurred by him by reason of the same;

(c) if execution or other process issued on a decree or order of any Court in favour of a creditor against the company, or any member thereof as such, or any person authorised to be sued as nominal defendant on behalf of the company, is returned unsatisfied in whole or in part;

(d) if it is otherwise proved to the satisfaction of the Court that the company is unable to pay its debts.

4. Contributories in winding up of unregistered company[72]

4.1 In case of winding up as aforesaid, every person shall be deemed to be a contributory, who is liable to pay, or contribute to the payment of, —

(a) any debt or liability of the company; or

(b) any sum for the adjustment of the rights of the members among themselves; or

(c) the costs, charges and expenses of winding up the company.

4.2 Every contributory shall be liable to contribute to the assets of the company all sums due from him in respect of any liability to pay or contribute as aforesaid.

[72] Section 585 CA 1956

4.3 In the event of the death or insolvency of any contributor, the provisions hereof with respect to the legal representatives of deceased contributors, or with respect to the assignees of insolvent contributories, as the case may be, shall apply.

5. Court's Power

5.1 Where an order has been made for winding up an unregistered company, no suit or other legal proceeding shall be proceeded with or commenced against any contributory of the company in respect of any debt of the co, except by leave of the Court and except on such terms as the Court may impose.[73]

5.2 If an unregistered company has no power to sue and be sued in a common name, or if for any reason it appears expedient, the Court may, by the winding up order or by any subsequent order, direct that all or any part of the property, movable or immovable (including actionable claims), belonging to the company or held by trustee on its behalf, shall vest in the Official Liquidator by his official name; and thereupon the property or the part thereof specified in the order shall vest accordingly. The Official Liquidator may, after giving such indemnity, if any, as the Court may direct, bring or defend in his official name any suit or legal proceeding relating to that property, or which it is necessary to bring or defend for the purposes of effectually winding up the company and recovering its property.[74]

6. Recordal of Information:

· Foreign companies which establish a place of business within India shall, within one months of the establishment of the place of business, deliver to the Registrar of Companies for registration[75]-

(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 the English language, a certified translation thereof;

(b) the full address of the registered or principal office of the company;

(c) a list of the directors and secretary of the company containing the following particulars -

(with respect to each director) (i) in the case of an individual, in his present name and surname in full, any former name or names and surname or surnames in full, his usual residential address, his nationality and if that nationality is not the nationality of origin, his nationality of origin, and his business occupation, if any, or he has no business occupation but holds nay other directorship or directorships, particulars of that director ship or of some one of those directorships; and (ii) in the case of a body corporate, its corporate name and registered or principal office, and the full name, address, nationality, and nationality of origin, in different from that nationality, of each of its directors;

[73] Section 587 CA 1956
[74] Section 588 CA 1956
[75] Section 592 CA 1956

(with respect to the secretary, or where there are joint secretaries, with respect to each of them) in the case of an individual, his present name and surname, any former name or names and surname or surnames, and his usual residential address; and in the case of a body corporate, its corporate name and registered or principal office;

(d) the name and address or the names and address of some one or more persons resident in India, authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company; and

(e) the full address of the office of the company in India, which is to be, deemed its principal place of business in India.

· Every foreign company, in every calendar year, is required to[76] —

(a) make out a balance-sheet and profit and loss account in such form, containing such particulars and including or having annexed or attached thereto to such documents (including, in particular documents relating to every subsidiary of the foreign company) as if it is a domestic company; and

(b) deliver copies of those documents to the Registrar;

· **Penalties**:[77]

If any 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 with fine which may extend to one thousand rupees, and in the case of a continuing offence, with an additional fine which may extend to one hundred rupees for every day during which the default continues.

· **Effect of Offence**:[78]

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 any such contract dealing or transaction, until it has complied with the provisions as above.

7. Miscellaneous Provisions:

· Apart from the above, the provisions pertaining to the registration of charges, appointment of receiver and books of account as applicable to the domestic companies shall apply mutatis mutandis to the foreign companies as well.[79]

[76] Section 594 CA 1956
[77] Section 598 CA 1956
[78] Section 599 CA 1956
[79] Sections 124-145, 209, 600 CA 1956

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?

There is no provision under the Indian Law, statutory or otherwise.

QUESTION 11

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

11.1 (i) In India, when a rehabilitation scheme for revival of an insolvent company is under consideration, it may contemplate fresh financial assistance and/or additional financial burden by way of interest on deferred/re-scheduled payments. The earlier credits also continue but with the difference that now they are part of the rehabilitation scheme. Under the provisions of Sick Industrial Companies (Special Provisions) Act, 1985, every scheme for rehabilitation is monitored by an agency appointed by the BIFR. I have already discussed in reply to Question No.2 as to what liabilities can Director incur during the period when a scheme for rehabilitation of an insolvent company is under implementation. Therefore, the responsibility of Directors is much higher during this period in respect of further credit as there is direct supervision of BIFR and the liabilities are much more serious. Although there are very few instances where the Directors have been penalised by directing them to restore the property or money or make good the loss, but there have been cases where observations have been made against the Directors by BIFR which have had the consequences of informal blacklisting of these Directors and the companies in which they are Directors, from further financial assistance in future.

(ii) The Court is empowered to injunct the Directors from dealing with and/or disposing of the assets during the insolvency proceedings except in the ordinary course of business. Normally Courts issue such directions at instance of creditors. However, during the period when a rehabilitation scheme is under implementation, such a direction may not be given. In such cases, Directors, ought to watch the interests of the creditors of their company as but for their consent, rehabilitation scheme would not have been approved and further because, serious Misfeasance, mal-feasance and non-feasance proceedings are attracted.

(iii) While the relevant legislations in India are drafted in such a manner that they strike a balance between the two, the company's rehabilitation and recovery of creditors money and safeguarding of its interest but in practice, the experience has been that the creditor has largely been put to disadvantage. Directors not only render the company insolvent by mismanagement and misfeasance, they escape the consequences by seeking protection under SICA and further get away without paying dues of creditors for number of years and continue to enjoy possession and use of the assets.

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 (i) As is the situation in most of the legal systems all over the world, in India too, the period preceding the commencement of insolvency proceedings is vulnerable. Under Indian Law, every transaction preceding one year of the presentation of insolvency proceedings is questionable as per the provisions of the Companies Act, 1956. Under SICA, the creditors can question transactions of the company while its accounts and financial affairs are being scrutinised for determining whether it has become insolvent. While the High Court has the power to set aside such transactions after following the principles of natural justice, BIFR can only make observations and consider reverse entries by taking into account the loss that may have occurred due to under value 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.

(ii) There are no means whereby a potential buyer wishing to buy assets from a Company facing insolvency would know that a Liquidator would not try and seek to get the transaction aside. While scrutinising the accounts, if the Liquidator feels that a particular transaction was glaringly undervalue and thus, questionable, it could become subject matter of setting aside proceedings. Obviously, once it is definitely concluded that the sale was not bona-fide and that it highly undervalued to compromise with company's interest, it would be set aside. The property would be put to resale. But the buyer or person in possession having bought from original buyer from the company would be given the first preference if he were able to meet the market value.

(iii) It is advisable to obtain proper professional advice before entering into any transaction. The solution could be obtaining an Indemnity Bond indemnifying against future loss owing to setting aside of sale for above reasons.

(iv) 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 thereof. In such cases, the other creditors find themselves in a dilemma particularly if the creditor, which has entered into a transaction, has very high stakes and has charge over the assets of the company and has first preference in terms of repayment of debt. Thus, the third parties are always at risk. Even those assets, which are sold as court sale, become subject matter of litigation for years together.

QUESTION 12

12. Time period preceding insolvency within which the relevant act must have been undertaken so as to attach personal liability to the director.

The time period or `timeline' to say so within which an act must have been undertaken by the director so as to make him personally liable varies depending on the nature of offence. In case of certain offences the `timeline' is stipulated under the relevant statutory provision(s) itself whereas in some cases it depends on the nature and circumstances of individual case as scrutinised by the Court. Different cases are discussed below-

12.1 Misconduct-[80]

A director can misconduct himself by committing certain acts as have been discussed in detail under Question/Chapter No.2. He could be held liable for misconduct if he undertook certain acts or committed certain offences within 12 months immediately preceding the commencement of the winding up proceedings. He could also be held liable for misconduct if he undertook certain acts or committed certain offences during the winding up proceedings (continuing until dissolution of the said company). Hence, in cases of misconduct, the `timeline' could be defined in the following manner –

TIMELINE (1) = 12 Mths (Preceding Commencement Of Winding-up)
TIMELINE (2) = Duration of Winding up Proceedings (until dissolution of the company)

· Briefly, following acts if committed within above defined `timeline (1)' could constitute acts of misconduct:

(a) Concealment of any part of the property of the company or any debt due to or from the company;

(b) fraudulently removal any part of the property of the company to the value of one hundred rupees or upwards;

(c) concealment, destruction, mutilation or falsification, or being privy to the concealment, destruction, mutilation or falsification of, any book or paper affecting or relating to, the property or affairs of the company;

(d) making, or being privy to the making of, any false entry in any book or paper affecting or relating to the property or affairs of the company;

(e) fraudulently parting with, alters or making any omission in, or being 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;

[80] Section 538 Companies Act, 1956

(f) by false representation or other fraud, obtaining on credit, for or on behalf of the company, any property which the company does not subsequently pay for;

(g) under the false pretence that the company is carrying on its business, obtaining on credit, for or on behalf of the company, any property which the company does not subsequently pay for;

(h) pawning, pledging or disposing 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;

(i) at any meeting of the creditors of the company attempting to account for any part of the property of the company by fictitious losses or expenses;

· Briefly, following acts if committed within above defined `timeline (2)' could constitute acts of misconduct:

(a) making any material omission in any statement relating to the affairs of the company;

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

(c) preventing the production of any book or paper affecting or relating to the property or affairs of the company;

(d) 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;

(e) not, to the best of his knowledge and belief, fully and truly discovering 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 the business of the company;

(f) not delivering up to the Liquidator, or as he directs, all such part of the movable and immovable property of the company as is in his custody or under his control, and which he is required by law to deliver up;

(g) not delivering up to the Liquidator, or as he directs, all such books and papers of the company as are in his custody or under his control and which he is required by law to deliver up;

(h) at any meeting of the creditors of the company attempting to account for any part of the property of the company by fictitious losses or expenses;

12.2 Defrauding of Creditors[81]

This offence is committed by an officer of a company which is subsequently ordered to be wound up by the Court or which subsequently passes a resolution for voluntary winding up. Following acts constitute the offences under this head -

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

(b) with intent to defraud creditors of the company, 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 judgement or order for payment of money obtained against the company, or within two months before that date;

TIMELINE = There is no hard and fast rule as to maximum gap between the impugned transaction and the order of winding up by the Court or passage of a resolution for voluntary winding up. It all depends on the evidence to be adduced so as to prove that when the transaction took place, it was within the knowledge of the officer that the company was bound or likely to go in for liquidation.

12.3 Maintenance of Improper Accounts[82]

TIMELINE = The offence of the above nature must have been committed throughout the period of 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 so as to hold the director personally liable.

· The above offence is made out, if, in the course of winding up of a company, if it is shown that proper books of account were not kept in the company by the officer responsible for the same.

12.4 Falsification of Company's Books[83]

TIMELINE = This offence must have been committed when the company is being wound up.

· An offence under this provision is committed, if any officer or contributory of a company, which is being wound up, with intent to defraud or deceive any person, -

(a) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

[81] Section 540 Companies Act, 1956
[82] Section 541 Companies Act 1956
[83] Section 539 Companies Act 1956

(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.

12.5 Fraudulent Conduct of Company's Business[84]

TIMELINE = 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 individual case as scrutinised by the Court.

· The 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 persons, or for any fraudulent purpose. The 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.

12.6 Delinquency, Breach of Trust & Misfeasance: Directors and others[85]

TIMELINE = 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 individual case as scrutinised by the Court.

· 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;

12.7 Misfeasance Proceedings[86]

TIMELINE = 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 individual case as scrutinised by the Court.

· An offence is made out, 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 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–

(a) has misapplied or retained, or become liable or accountable for, any money or property of the sick industrial company; or

[84] Section 542 Companies Act 1956
[85] Section 543 Companies Act 1956
[86] Section 24 Sick Industrial Companies (Special Provisions) Act, 1985

(b) has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust in relation to the sick industrial company.

APPENDIX

INSOLVENCY PROCEDURE

Who could wind up a Company?

The winding up of a company may be either by the Court or voluntary or subject to the supervision of the court.[87]

Predominantly, we are here concerned with winding up by Court, as it is only the Court, which can wind up a Company in case of its insolvency or in other words the Company which is unable to pay/discharge its debts. We shall, hence, primarily touch upon only procedures connected with `Winding up by the Court'.

Winding Up By the Court

In the following circumstances or cases, the company may be wound up by Court-[88]

- if the company has resolved that the company be wound up by the Court;
- if the company fails to file the statutory report with the Registrar of Companies;
- if the company fails to hold its statutory meeting;
- if the company fails to commence its business within a year from its incorporation;
- if the company suspends its business for a whole year;
- if 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;
- if the company is unable to pay its debts;
- if the Court finds it just and equitable to wind up the company.

In the present context of insolvency of a company, the more relevant question is as to when can a company be deemed to be unable to pay its debts (so as to seek its winding up)?

The answer is as follows - A company shall be deemed to be unable to pay its debts[89]—

- 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;
- 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
- if it is proved to the satisfaction of the Court that the company is unable to pay its debts.[90]

[87] Section 425 Companies Act 1956
[88] Section 433 Companies Act 1956
[89] Section 434 Companies Act 1956
[90] 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.

Procedure for Petitioning -

[91]An application to the Court for the winding up of a company shall be by petition presented by the company or by any creditor or creditors, including any contingent or prospective creditor or creditors or by any contributory or contributories or by the Registrar of Companies. In certain cases of mismanagement, statutory violations etc., any person authorized by the Central Government in that behalf could also move a petition for winding up.

Voluntary Winding up
Subject to Supervision of Court

Where a company is being wound up voluntarily or subject to the supervision of the Court, 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' and the Official Liquidator.[92]

Commencement of winding up by Court[93] -

- **In case of 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 voluntary winding up, the winding up of the company shall be deemed to have commenced at the time of the passing of the resolution.[94]

- **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.

Powers of Winding up Court[95] -
On hearing a winding up petition, the Court may

- dismiss it, with or without costs; or
- adjourn the hearing conditionally or unconditionally; or
- make any interim order that it thinks fit; or
- make an order for winding up the company with or without costs, or any other order that it thinks fit;

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[96] to be liquidator provisionally.

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[91] Section 439 Companies Act 1956
[92] The Court shall not make a winding up order on a petition presented to it unless it is satisfied that the voluntary winding up or winding up subject to the supervision of the Court cannot be continued with due regard to the interests of the creditors or contributories or both.
[93] Section 441 Companies Act 1956
[94] The court, however, on proof of fraud or mistake, can direct that all proceedings taken in the voluntary winding up shall be deemed to have been validly taken.
[95] Section 443 Companies Act 1956
[96] Official Liquidator is a whole-time officer appointed by the Central Government and attached with the Winding up Court.

Consequences of winding up order-

- Where the Court makes an order for the winding up of a company, the same is conveyed forthwith to the Official Liquidator[97] and the Registrar of Companies.

- 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.

- 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 proceed with, against the company, except by leave of the Court and subject to such terms as the Court may impose.

- Soon after the winding up order, the Official Liquidator shall submit to the Court a detailed statement of affairs pertaining to the Company covering amongst other the following aspects - the amount of capital issued, subscribed, and paid up, and the estimated amount of assets and liabilities, cash and negotiable securities, debts due from contributories, debts due to the company and securities, if any, available in respect thereof, movable and immovable properties belonging to the company and unpaid calls.

- Where a winding up order has been made or where a provisional liquidator has been appointed, the liquidator shall take into his custody or under his control, all the property effects and actionable claims to which the company is or appears to be entitled.

- 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.

- The liquidator shall convene separate meeting of company's creditors and contributories for appointment of committee of inspection to act with the liquidator. A committee of inspection as appointed 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.

- As soon as may be after making a winding up order, the Court shall settle a list of contributories and shall cause the assets of the company to be collected and applied in discharge of its liabilities:

- The Court may, at any time after making a winding up order, require any contributory and any trustee, receiver, banker, agent, or officer of the company, to pay, deliver, surrender or transfer forthwith, or within such time as the Court directs, to the liquidator, any money, property or books and papers in his hands to which the company is prima facie entitled.

- When an order has been made for winding up a company by the Court, and the Official Liquidator has made a report to the Court under this Act, stating that in his opinion a fraud has been committee by any person in the promotion or formation

[97] 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.

of the company, or by any officer of the company in relation to the company since its formation, the Court may publicly examine the concerned person(s) as to the promotion or formation or the conduct of the business of the company, or as to his conduct and dealings as an officer thereof.

Effect of winding up order-[98]

- An order for winding up a company shall operate in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of a contributory.

Liability-

- As contributories of present and past members:- In the event of a company being wound up, every present and past member shall be liable to contribute to the assets of the company to an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of the winding up.[99]
- As directors, managing agents and managers[100]:- In the winding up of a limited company, any director, managing agent, secretaries and treasurers or manager, whether past or present, whose liability is unlimited shall, in addition to his liability, if any, to contribute as an ordinary member, be liable to make a further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.[101]

Dissolution of company-[102]

- 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.

[98] Section 447 Companies Act 1956
[99] Section 426 Companies Act 1956
[100] Section427 Companies Act 1956
[101] A past director, managing agent, secretaries and treasurers or manager shall not be liable to make such further contribution, if he has ceased to hold office for a year or upwards before the commencement of the winding up. A past director, managing agent, secretaries and treasurers 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.
[102] Section 481 Companies Act 1956

Notes

MEXICO

Introduction

Mexico is organized on a federal basis and under the Constitution, those powers not expressly vested on the federation are deemed reserved to the states.[1] Among those powers expressly granted the federal congress we find commerce.[2] Therefore, federal law governs all matters pertaining (i) to individuals habitually engaged in a commercial activity[3] and (ii) to commercial companies or corporations, as well as their insolvency. However, since civil law (as opposed to commercial law) falls within the jurisdiction of the states, the insolvency of individuals not engaged in commercial pursuits and that of civil (i.e., not for profit) companies is regulated by the civil codes of the several states. Due to the nature of the Twilight Zone Project, this paper deals exclusively with commercial companies.

Insolvency procedures - both reorganization and bankruptcy - are regulated by the "Ley de Concursos Mercantiles", which for the purposes of this paper will be referred to as the "Commercial Insolvency Law" ("LCM"). The LCM applies to all merchants - those persons habitually engaged in commercial activities - both individual and corporate.

In turn, corporations - and the duties and liabilities of their directors and managers --are governed by the "Ley General de Sociedades Mercantiles" or "Commercial Companies Law" ("LGSM").

QUESTION 1

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

1.1. 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?

Under the LCM, transactions entered into by a company that has been declared insolvent during a period known as the retroaction or reach-back period, with the intent to defraud creditors, can be set aside. The retroaction period begins on the 270th calendar day prior to the date of the Insolvency Declaration.

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

Yes, because a retroaction period cannot exist outside on Insolvency Proceedings.

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[1] Political Constitution of the United Mexican States (hereinafter "Constitution"), article 124.
[2] Constitution, article 73, section X.
[3] For a description of what constitutes commercial activity (or acts of commerce), see article 75 of the Commercial Code.

1.3. Does it depend on the nature of the transaction?

What depends on the nature of the transaction is not the start and duration of the retroaction period, but whether the transaction in question can be avoided or not.

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

As in the case of the prior question, what depends on whether the party to the transaction is connected or associated with the company is not the existence of the reachback period, but whether such transactions can be avoided or not.

1.5. Will any other circumstance lengthen or shorten the "Twilight Period"?

The LCM provides that the Judge upon motion from the Conciliator,[4] the Interventors,[5] or any creditor, can extend this period backwards, lengthen it, if the motion is filed prior to the issue of the order of recognition of creditors and ranking of credits.[6] However, the LCM does not contemplate a shortening of the period.

QUESTION 2

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2. Actions potentially giving rise to liability for directors.

2.1. 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?

Directors are liable for any acts or malicious conduct that causes or aggravates the situation of general non-performance of the debtor in the payment of its obligations.[7] The LCM presumes *iuris tantum* that the debtor has caused or aggravated the situation of general non-performance of the debtor in the payment of its obligations when the debtor's accounting is kept in such a manner that it does not allow knowledge of its true financial situation, or when it is altered, falsified or destroyed.

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[4] The Conciliator is the person appointed under the LCM to supervise the management of the debtor's business during the Conciliation or Reorganization phase of the Insolvency Proceedings, if the debtor remains in possession of the same, and to manage it if the debtor is removed. During the Bankruptcy or Liquidation phase of the Insolvency Proceedings, a person called Síndico, who can be the same one who acted as Conciliator, assumes these functions.

[5] Interventors are those persons appointed by a creditor or groups of creditors representing at least 10% of the debtor's liabilities to represent their interests and to supervise the performance of the Conciliator and/or the Síndico and the management of the business by the debtor when it remains in possession of the same.

[6] LCM, article 112.

[7] The test established by the LCM for Insolvency Proceedings is not a balance sheet test, but rather a cash flow, or liquidity, test. Article 9 of the LCM provides that "(T)he Merchant who incurs in a general non-performance in the payment of its obligations shall be declared insolvent", and in article 10 set forth those case in which the LCM presume there has been such a general non-performance.

(a) In relation to each act identified in (2.1) above:

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

It can be both, criminal and civil. In any event, if only criminal charges are levied, part of the procedure includes a hearing —before the criminal judge— on what is known as "damage reparation" ("reparación del daño"), which in essence is the civil liability the person found guilty of a crime is sentenced to pay to the victim of the same. However, in the case of crimes under the LCM, the "damage reparation" hearing is held not before the criminal judge, but before the insolvency judge,[8] and reparations are payable to the Estate.

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

Yes. Under LGSM, a Director is jointly and severally liable to the company with his/her fellow Directors, for any damages caused to the same, unless he/she is exempt from fault and stated his/her opposition at the time of deliberation and resolution of the act in question.[9]

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

As mentioned above, Directors are jointly and severally liable to the corporation. Therefore, their individual liability will be in proportion to the number of Directors there are. And in the event a court orders any one of them individually to pay the full amount of any given claim, under the rules of the Federal Civil Code ("CiCo") governing joint and several liability, which provides that joint and several debtors are liable among them in equal parts, they can sue the other Directors to recover from each one of them the corresponding proportional part of the damages paid.[10]

(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

No. Directors are liable at all times to the corporation for any damages that their misconduct may have caused it during the period they held office.

(v) What defenses, if any, will be available in relation to each offense?

The first defense would be that he/she did not participate in the approval of the relevant act. A further defense would be, if such were the case that the statute of limitations had operated.

[8] LCM, article 276.
[9] LGSM, articles 156 to 163.
[10] See, Federal Civil Code, article 1999.

1. *General fiduciary duties*

The concept of fiduciary duty as understood by the law of other jurisdictions - notably the laws of the United States of America and of the United Kingdom - is not as developed in Mexican law, and it is seldom - if ever - applied beyond the realm of the trust agreement ("contrato de fideicomiso") itself. In this regard, the Negotiable Instruments and Credit Operations General Law ("Ley General de Títulos y Operaciones de Crédito" - "LGTOC"), provides that trustees "shall always act as a good *pater familias*",[11] which under modern management theory and practice is a very conservative and limitating provision, as it does not allow for the assumption of any risk whatsoever. However, for Directors, a standard of proper care is understood, in that the LGSM deems them to be "temporary and revocable attorneys",[12] and under the CiCo, attorneys, when authorized to act upon their judgment, "shall act as prudence dictates, taking care of the business as if were its own".[13] Finally, when the company has been granted credit that is secured *in rem* by a non-dispossessory pledge, the company - and thus its Directors and senior managers¾ are deemed to be depositories of the pledged assets and as such, under the Commercial Code ("Código de Comercio" – "CoCo") they have an obligation to exercise due care in the safekeeping of such assets, being liable for any damages or losses caused through their malice or negligence.[14]

2. General Bankruptcy Offenses under the LCM

Criminal liability for any offenses committed by a corporation under the LCM falls on its Directors, managers and liquidators that are the authors or accomplices of the offense.[15]

In this connection, the LCM typifies as criminal offenses (i) the commission of any acts or of any malicious conduct that causes or aggravates the situation of general non-performance of the debtor in the payment of its obligations, which is punished by imprisonment of from one to nine years; and (ii) not providing its accounting books and records to the person designated by the judge, within the term established by the judge, except for force majeure.

3. *Failure to keep proper books of account*

Under the LCM, as well as under the Federal Tax Code ("Código Fiscal de la Federación" – "CFF"), failure to keep proper books of account is a criminal offense.[16] However, if the Directors can prove that despite adequate supervision, such book were improperly kept, then they would be exempt from liability.

[11] LGTOC, article 356.
[12] LGSM, article 142.
[13] CiCo, article 2563.
[14] LGTOC, article 329 and CoCo, article 335.
[15] LCM, article 273.
[16] LCM, article 271. CFF, article *.

4. *Unlawful transactions*

Unlawful transactions *per se*, by definition, are punishable, either civilly or criminally, depending on the nature of the offense. And liability therefor will always fall on the perpetrator. If the misdeed is attributable to a corporation, then its Directors and managers who participated in the same are liable to the corporation for reimbursement of any damages and losses the same might have suffered by their malfeasance, independently of any criminal penalties the law might impose upon them personally.

5. *Declaration of dividends*

Under the LGSM, dividends can be declared only by the stockholders' meeting and never by the Board of Directors, and only after financial statements that actually show a profit have been approved by the stockholders' meeting.[17] However, if a dividend is paid in violation of the above, Directors who made the payment are jointly and severally liable to the corporation and to its creditors for any damages suffered by it.[18] Obviously, if the Directors do not recommend the payment of a dividend, or if there are not sufficient profits for paying one, and in spite thereof the stockholders declare a dividend, the Directors will not be liable.

6. *Liability for debts due to employees*

Under Mexican law, Directors are not personally liable for debts due by the corporation to its employees.

7. *Oppression and derivative action*

As stated above, Directors are liable to the corporation, only, and not to its stockholders or creditors. Thus, the law does not contemplate derivative actions.

8. *Community Service*

There is no provision in Mexican law for this type of penalties.

9. *Compensation for Loss*

As in any other legal system, anybody who intentionally or through negligence unlawfully causes a loss to somebody else must compensate such person for any damages and losses suffered by it.[19]

[17] LGSM, articles 19, 180 and 181.
[18] LGSM, articles 19 and 158, section II.
[19] CoCi, articles 1910 *et seq.*

QUESTION 3

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

3.1. 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?

Yes. In addition to Directors, also liable are the administrators, managers and liquidators of the corporation who are material authors or accomplices to the relevant act.[20]

Also liable: (i) the spouse, male or female concubine, relatives by consanguinity up to the fourth degree and by affinity up to the second degree and in-law relatives of Directors or administrators with whom an avoidable transaction was made during the reachback period; (ii) those individuals who jointly or severally, directly or indirectly, hold at least 51% of the subscribed and paid-in capital stock of the insolvent corporation, or who have a deciding power at the stockholders' meetings, or who are in a position to appoint the majority of the Directors, or who by any other means have the power to take the fundamental decision of the corporation, with whom an avoidable transaction was made during the reachback period; (iii) those corporations with which there exists a coincidence of Directors, administrators or senior managers, with which an avoidable transaction was made during the reachback period; and (iv) those corporations controlled by the insolvent corporation with which an avoidable transaction was made during the reachback period.[21]

Further, any person who acquires assets of the insolvent corporation in bad faith and in order to defraud creditors must return such asset to the Estate.[22] But if the asset has been transferred to a third party acting in good faith, or it has been lost, or if in order to prevent the avoidance of the transaction the asset has been hidden or destroyed, then such person is liable to the Estate for damages and losses.[23]

And finally, any person who by itself or through third parties files for the recognition of an inexistent or simulated claim is subject to imprisonment of from one to nine years.[24]

[20] LCM, article 273.
[21] LCM, article 117.
[22] LCM, articles 113 and 119.
[23] LCM, article 118.
[24] LCM, article 274.

3.2.1. 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?

See reply to question 3.1, above.

3.3. 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?

Liability is limited to that resulting from involvement with a particular transaction, and it is either to the insolvent corporation itself or to the Estate, with the above noted exception of improperly paid dividends, where liability to creditors also exists.

QUESTION 4

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

4.1. 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?

Since the reachback period arises only upon an Insolvency Declaration being issued, counterparties dealing at an arm's length with the company during this period ¾ when it is not insolvent, when it has not yet been declared insolvent¾ will assume that the company is conducting business normally. And unless they knowingly engage in transactions designed to defraud creditors, no avoidability will arise.

In any event, and regardless of the LCM provisions to this effect, under the *actio pauliana* provisions of the CiCo any acts committed in order to defraud creditors can be voided, when from such acts the insolvency of the debtor results.[25]

4.2. What defenses, if any, to the areas of vulnerability identified above will be available to a counterparty seeking to protect a transaction from being attacked?

In both cases, that of the reachback period and that of the *actio pauliana*, for the transaction to be voided *scienter* is required. Thus if the counterparty entered into the challenged transaction in good faith, at an arm's length and without knowledge of the debtor's intent to defraud its creditors, the transaction will stand.

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[25] CiCo, articles 2163 to 2179.

However, it must be pointed out that the LCM establishes a presumption *iuris et de iure* that any gratuitous transfers are made with knowledge of the debtor's fraudulent intent and therefore are always voidable.

QUESTION 5

5. Enforcement

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

Actions under the LCM can be brought by either the Conciliator, the Síndico, the Public Attorney and any creditor, depending on the nature of the conduct being complained of.

Avoidance actions will normally be brought by the Conciliator or the Síndico, as representatives of the Estate. But even while the LCM is silent on this point, and in the absence of a prohibition to that effect, it can be construed as allowing any interested creditor to bring such an action, in the understanding that any recovery will be for the benefit of the Estate.[26]

QUESTION 6

6. Remedies: order available to the domestic court

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

Under the LCM —and under the principles of unity and of modified universality adopted by it— all incidental or ancillary procedures relating to an insolvency —except for those relating to a transnational insolvency, to which the provisions of the UNCITRAL Model Law, as adopted by Mexico, apply[27]— have to be heard by the judge conducting the main proceedings. Those for which the LCM does nor expressly provide a specific procedure will be heard through an abbreviated procedure known as an "incident" ("incidente"), which is regulated in the LCM itself.[28] Therefore, any action brought to avoid transactions that took place during the reachback period has to be brought before the insolvency judge under the incidental procedure mentioned above.

[26] LCM, articles 113, 118 and 119.
[27] LCM, Title XII, articles 278 to 310.
[28] LCM, article 267.

QUESTION 7

7. Duty to co-operate.

7.1. 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 debtor and its Directors, administrators, managers and employees are obligated to collaborate fully not only following the declaration of insolvency, but even from the time an application for such a declaration has been filed and an Examiner has been designated to determine whether the debtor meets the insolvency test established in the LCM. Lack on cooperation at this stage results automatically in the Insolvency Declaration.[29]

7.2. Are any human rights laws applicable in the domestic jurisdiction in relation to any such obligations?

Under the Constitution human rights are fully protected, and redress for their violation can be sought through the "amparo" proceedings. Among the most important rights that bear on the subject matter of this paper, we have the provisions of articles 6 (freedom of speech), 8 (right of petition), 14 (non retroactivity of the law, due process of law, exact application of the law), 16 (due process of law), 17 (no self-help remedies, prompt and free administration of justice) and 18, 19, 20, 21, 22 and 23 (criminal justice guarantees)

QUESTION 8

8. Appeals and limitation periods

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

The LCM does not establish limitation periods for any of the offenses created under it. Thus the general limitation rules apply.

For civil actions that deal with commercial matters, the CoCo establishes limitation periods, depending on the case, of one and five years; and provides for a ten-year period for all those cases not specifically limited to a shorter period.[30] Therefore, since, as stated, the LCM does not establish limitation periods, and

[29] LCM, articles 35 and 150.
[30] CoCo, articles 1043 (one year), 1045 (five years) and 1047 (ten years).

since such offenses are not included either in the one-year or five-year period provisions, the limitation period for civil liability under the LCM is of ten years.

As to an *actio pauliana*, the limitation period thereof is of two years.[31]

And regarding criminal offenses under the LCM, since the same require a complaint from the insolvent debtor or its creditors, the limitation period established by the Federal Penal Code ("CPF"), the provisions of which supplement the LCM in this area, is of one year, counted from the date on the persons entitled to lodge a complaint have knowledge of the crime, and of three years in other circumstances. If the complaint has been filed, then the limitation period is equal to the arithmetical mean of the time of imprisonment. [32]

In this connection, there seems to be an omission or *lacuna* in the LCM. Since under article 54 of the LCM, the Examiner, the Conciliator and the Síndico have the obligations and powers expressly granted them by the Law, and since article 275 thereof does not make specific reference to the Conciliator or Síndico, to allow them to file complaints for crimes under the LCM, which persons, by a majority of reason, should be the first ones entitled to file criminal complaints, it would seem that they do not have this power. Therefore, because of the newness of the LCM, it remains to be seen how the courts resolve this issue.

8.2. Please indicate whether an appeal is available from the decision of the lower courts.

Yes, decision of lower courts can always be challenged. Mexican procedural law recognizes two kinds of challenges: revocation, which is brought with and heard by the judge who issued the challenged order, and appeal, which is brought with and heard by the appeals court to which the challenged judge reports. Under the LCM, if the law itself does not provide for an appeal, revocation will be in order, which will be heard under the procedural rules of the CoCo.[33]

[31] CoCi, article 1161, section V.

[32] CP, article 107. What "mean time of imprisonment means", is the average of the minimum and maximum imprisonment time provided for in the law. Thus in the case of article 271 of the LCM, which establishes a minimum imprisonment of one year and a maximum of nine years, one adds the minimum (1) and the maximum (9), which comes to ten, and thus the average ¾ the mean ¾ is of five years, which is the time of the limitation period.

[33] LCM, article 268.

QUESTION 9

9. Foreign corporations

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

Yes, they apply to anybody, national or foreign doing business in Mexico. Specifically, the LCM allows branches of foreign corporations operating in the country to be declared insolvent, such declaration affecting the branch only, and not the parent company.[34]

QUESTION 10

10. Insurance

10.1. 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 1-9 above?

The LGSM used to require Directors and senior managers to guaranty the performance of their duties, but the provision was changed to make it instead of mandatory optional for a company's by-laws to require such guaranty. In practice, by-laws used to require the deposit with the company's treasury of a nominal amount of shares of the company' itself, or the posting of a bond in amount equal to the value of the required number of share; but given the nature of the Directors' and managers' potential liabilities, such security is in practice ineffective. Therefore, since the LGSM was amended, the practice has become not to require the posting of any guaranty at all. And since Mexican insurance companies do not provide directors' and officers' insurance, any recoveries against Directors and senior managers will be limited to whatever their personal wealth might be.

[34] LCM, article 16.

QUESTION 11

11. Financing

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

From the lender's point of view, lending monies to a company that is not insolvent, is as safe as the credit analysis that any prudent lender must perform makes it to be. If the credit transaction is done in the ordinary course of business and without the intent to defraud other creditors - which intent the later lender must have knowledge of - the transaction stands, and even if it took place during the reachback period, that should not present an obstacle for its proper recognition and ranking. However, if the loan is made under terms and conditions that depart significantly from prevailing market conditions at the time it was made, or from normal commercial usage and practice, then the transaction is voidable, unless the Estate benefited from the same.[35]

From the Directors' point of view, the raising of new money, if invested properly, should allow the company to improve its financial condition, as it would allow it to keep current in its payment obligations. But if with the new loan the Directors cause or aggravate the company's situation of a general non-performance of its payment obligations, then they will be criminally liable, as indicated earlier in this paper.

Finally, under the Credit Institutions Law ("Ley de Instituciones de Crédito" – "LIC"), it is a crime to borrow money from a bank on the basis on false data regarding the assets or liabilities of the borrower, or materially incorrect appraisals of assets, if from such a conduct the bank incurs in a loss. Thus, if Directors of a corporation - insolvent or not - incur into this kind of conduct, they will be criminally liable. The penalty is of from three months to three years imprisonment and a fine of from 30 to 500 hundred times the amount of the general minimum wage for the Federal District, if the loss to the bank does not exceed 500 times the amount of the general minimum wage for the Federal District; if it exceeds this amount, the penalty is of from two to ten years imprisonment and a fine of from 500 to 50,000 the amount of the general minimum wage for the Federal District.[36] Prosecution of these crimes requires a prior complaint from either the Ministry of the Treasury ("Secretaría de Hacienda y Crédito Público") or the affected bank.[37]

[35] LCM, article 114, section III.
[36] LIC, article 112, sections I and III.
[37] LIC, article 115

NETHERLANDS

QUESTION 1

1 The start and duration of the "twilight" period

In the Netherlands there is no such thing as a formal twilight period, being a period prior to bankruptcy during which all acts and doings of a company may be questioned or undone.

However, when insolvency is imminent - i.e. when the management of a company has serious reasons to believe that the company may in the not so far away future not be able to meet its obligations - certain types of liability that always exist gain importance because in practice these liabilities will only become an issue in case of a bankruptcy.

In the first place management, when entering into a transaction has to consider whether the company will be able to meet the obligations resulting from that specific transaction. If later it appears that the company is indeed not able to honour its obligations, management may face actions by the disappointed counterparty because entering into a transaction knowing that it is not unlikely that the company will not be able to meet its obligations constitutes tort.

Secondly there is the legislation with regard to mismanagement. If a company goes bankrupt and this bankruptcy is for a substantial part caused by mismanagement in the period of three years before the bankruptcy, the administrator in bankruptcy may hold management liable for the entire deficit in the bankruptcy (article 2:138 NCC and 2:248 NCC). Mismanagement is deemed to exist if certain administrative obligations such as carefully keeping the books of the company and timely publishing the annual accounts are not complied with. Management facing insolvency should therefore always investigate whether these administrative duties have been carefully observed.

Another liability that always exists but gets more important when insolvency is near, is the liability vis-à-vis the fiscal authorities. If certain taxes, social security premiums and pension premiums are not paid in time by a company, the management of that company will be personally liable for these taxes if it is because of mismanagement that these taxes are not paid. Mismanagement is assumed to exist if the fact that the Company is not able to meet its obligations has not been timely and in the correct form been reported to the relevant authorities. This is one of the most common forms of liability for managers of companies and although strictly speaking not limited thereto, in practice this liability arises mainly in bankruptcy and insolvency situations.

Not taking timely action to defend against an imminent bankruptcy may also trigger liability vis-à-vis the shareholders of the company. Bringing the shareholders into the often difficult decision process would seem to be in most instances the adequate response to this threat.

Transactions that are advantageous to certain and at the same time harmful to other creditors may, if the parties who entered into this transaction knew this, be

declared null and void (article 3:45 NCC; "Actio Pauliana"). This rule applies whether a bankruptcy is imminent or not. However, in case of a bankruptcy the burden of proof with regard to the knowledge of the fact that an action was detrimental to the creditors is for certain transactions shifted to the defending party. Managers who enter into this type of transactions may face personal liability based on tort and also criminal liability.

1.1 Introduction; no formal twilight period

1.1.1. The Netherlands Bankruptcy Act of 1896 (hereinafter: "NBA") is presently under review. Although in the past changes have been made to the NBA, the present review is no doubt going to lead to fundamental changes in the NBA within the next year or two. The NBA contains three types of insolvency proceedings: bankruptcy ("*faillissement*"), suspension of payments ("*surseance van betaling*") and debt restructuring for natural persons. Discussions on management liability, nullity of transactions and liability of third parties arise, as a rule, in case of bankruptcy. Bankruptcy ("*faillissement*") is a procedure applicable to both natural persons and legal entities, such as corporations. As in many other civil law jurisdictions, the court involvement in formal insolvency proceedings is rather strong. It is the court that opens the proceedings, it is the court that appoints the insolvency administrator ("*curator*"), and it is the insolvency court that will, as a rule, hear all cases related to the bankruptcy proceeding. Albeit being a civil law jurisdiction, in the Netherlands rulings and judgments of specifically the Supreme Court of the Netherlands are as a rule accepted by the lower courts as precedents. Specifically issues of management liability based on the general action of tort (6:162) are strongly influenced by the judgements of the Supreme Court.

1.1.2. The two types of companies generally used in the Netherlands are the "Naamloze Vennootschap" ("N.V.") and the "Besloten Vennootschap" ("B.V."). Both are legal entities with capital divided in shares, minimal capital requirements and a liability of shareholders which is limited to the amount payable to the company on the shares held. Shareholders or management normally assume no liability vis-à-vis creditors of the company. One or more (statutory) managing directors ("directeuren") manage both NV and BV. Sometimes management is supervised by a Supervisory Board ("Raad van Commissarissen"). Generally speaking only one or more directors can represent and bind the company, members of the Supervisory Board cannot. The Supervisory Board should supervise and that Board is sometimes required by law or statute to approve documents such as the annual accounts or to approve certain envisaged decisions of management. Management and Supervisory Board have a duty of care vis-à-vis the company itself and the parties related to that company, e.g. employees, creditors and shareholders.

1.1.3. Unlike some other civil law jurisdictions, Dutch insolvency law does not urge management of a company to apply for moratorium or bankruptcy on the basis of a cash-flow test or a balance-sheet test. Companies (and management) are in principle allowed, under Dutch law, to continue business even if the equity is negative. Also no formal cash flow test has been provided for in the law. However, the management of an NV is obliged to inform its shareholders as soon as the management may reasonably assume that the net asset value of the company is less than 50% of the paid in and called in capital (article 2:108a NCC). Besides

that, some quite distinct general rules of law become of great importance once a company gets into cash flow problems. One of those concepts of law is the doctrine based on the Supreme Courts decision in the Beklamel case. Under this doctrine a managing director who accepts on behalf of the company an obligation, while this managing director knows or should have known that the company will not be able to fulfil that obligation timely nor will grant sufficient recourse for damages, is privately and personally liable for the damages of such creditor (see: 6.1). This rule will urge management to take action if cash flow problems are foreseen in order to avoid the risk of private liability.

1.1.4. As Dutch law has no formal balance-sheet test or cash-flow test, there is no formal twilight period during which transactions entered into by a bankrupt company may be successfully attacked or may give rise to private liability of management. Apart from few specific provisions relating to bankruptcy (see 1.2), both nullity or claw back actions and liability actions can be based on various concepts of law, mainly the “Actio Pauliana”,tort-actions (see: 4.1.), and breach of duty vis-à-vis the company (see: 6.1. article 2:9 NCC) In general, the normal time-bars apply (usually 5 years).

1.2 Specific periods for specific forms of liability; shift of burden of proof

However, some specific periods for specific forms of liability do exist:

a) Payments of claims that were due and payable may, provided there is no “conspiracy” between the debtor and the creditor, be declared null and void only if the creditor knew that a petition for bankruptcy had been filed (art. 47 NBA). The average period between the filing by a creditor and adjudication of bankruptcy by the court is between 2 and 4 weeks. An application by the debtor-company itself for its own bankruptcy may lead to bankruptcy within one day.

b) Claims of the *curator* (see: 1.1.1) against management for the total deficit or damages, based on “mismanagement” can only be based on facts and circumstances that took place within 3 years before the bankruptcy (see: 6.1. below; art. 16 LCSP, 36 TCA and 2:138 and 2:248 NCC). With regard to claims of the fiscal and social security authorities based on mismanagement also a three year period applies. This period, however, is not linked to the bankruptcy but to the moment on which the company filed or should have filed its inability to pay taxes.

c) With regard to the following transactions which took place within the period of one year before the bankruptcy:

   i) transactions with insiders,
   ii) transactions whereby the value of the transaction on the debtor’s side substantially exceeds the value on the creditor’s side, and
   iii) transactions whereby the debtor provides security for a not yet claimable debt, the law provides for a shift in the burden of proof if the *curator* invokes the Actio Pauliana, an invalidation action: the contracting parties have to prove that they did not know that the transaction was detrimental to the creditors of the company (art. 43 NBA).

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

Director's liability arises both on the basis of general concepts of law (tort, negligence, breach of duty of care) and some specific articles in the NCC and NBA.

Director's liability vis-à-vis the company itself (which means in case of a bankruptcy the curator of that company or its *curator*) has a broad basis in article 2:9 NCC: the duties of care of the manager vis-à-vis the company (see: 6.1.a)

Directors liability vis-à-vis a specific creditor shall as a rule be based on tort (see 6.1.c. and 6.1.d.), such as the "Beklamel"-type of action (see: 1.1.3) or misleading (annual) accounts (2:249 NCC).

Directors liability vis-à-vis the *curator* for the deficit of the bankruptcy may only be based on mismanagement (see: 6.1.c.). The curator may also start actions against a direct or based on tort.

2.2 Falsification of the company's books

a) A managing director who falsifies the books will most likely be liable vis-à-vis the company because he does not perform under his duty as a managing director of the company (article 2:9 NCC).

b) If the books are falsified and the company is subsequently declared bankrupt, it is assumed that the bankruptcy is caused by mismanagement of the

managing director and the director is liable vis-a-vis the curator for the entire deficit in the bankruptcy (2:138 or 2:248 NCC)[1]

c) Similar liabilities as mentioned under b. exist vis-à-vis the tax and social security authorities for certain tax and social security debts (36 TCA).

d) The falsifying manager also faces criminal liability, although prosecution is rare.

e) The liabilities mentioned under a. and d. are in principle individual liabilities;

f) The liabilities under b. and c. are joint and several liabilities

g) For the liabilities under b. and c. the 3-year period mentioned under 1.b. applies. For the other forms of liability the normal statute of limitation of the NCC applies (5 years after the falsification has been discovered).

h) Vis-à-vis the company the managing director may put that the company has not suffered any damages; vis-à-vis the liquidator and the tax and social security authorities hardly any defence is possible in case of falsification of the books.

2.3 Transactions in fraud of creditors

a) Transactions in fraud of creditors may give rise to both civil and criminal liability.

b) In proceedings based on prejudice to the creditors ("Actio Pauliana") a managing director may be personally liable for losses caused by the transaction. However if the transaction also constitutes mismanagement and this mismanagement was an important cause of the bankruptcy, the managing director may be liable for the entire deficit in the bankruptcy. Mitigation by the court is possible.

c) Individual managing directors who were involved in the transaction will be jointly and severally liable irrespective of their share of involvement. Managing directors who were not involved are not liable unless there is mismanagement, which was an important cause of the bankruptcy.

d) There is no specific period prior to the commencement of the bankruptcy in which the relevant act must have been undertaken. The general time bar of 5 years applies. Note that any liability for the deficit of the insolvency proceedings can only be imposed if mismanagement took place in a period of three years prior to the bankruptcy.

[1] The articles 2:138 and 2:248 are not limited to falsification of the books. They have the broader scope that any mismanagement that was an important cause of the bankruptcy may lead to personal liability of the managers. However, in case of falsification of the books such mismanagement is assumed and hardly any defence is possible.

2.4 Extortionate credit transactions

a) There are general provisions on extortion in the Criminal Code and there are provisions in the Act on Consumer Loans. However there are no provisions on extortionate credit transactions specifically relating to insolvency. It is conceivable that "extortionate credit transactions" sometimes also constitute transactions in fraud of the creditors (see: 4.1.b).

2.5 Fraud in anticipation of winding up

a) If managing directors entered into new contracts or if they enticed creditors to extend their existing credits by fraud in anticipation of a bankruptcy, this may give rise to civil liability (see: 1.1.3.above: Beklamel-type of actions). Under certain circumstances this type of fraud may also entail criminal liability, but prosecution is rare.

b) In general this type of fraud will lead to liability of the manager for the losses suffered by the specific creditor(s) concerned.

c) Individual directors who were involved in the transaction will be jointly and severally liable irrespective of their share of involvement. Directors who were not involved are not liable.

2.6 Breach of general / common law duties owed to the company (e.g. not to commit preferences)

a) The duty of care of a director is primarily a duty owed to the company (see: 1.1.2) Breach of duties owed to the company will result in civil liability vis-à-vis the company or its *curator*.

b) Such liability relates only to the loss caused by the breach of duty. When there has been mismanagement, which was an important cause of the bankruptcy, there may be liability for the entire deficit in the bankruptcy.

c) Individual directors who were involved in or responsible for the breach will be jointly and severally liable irrespective of their share of involvement. Directors who were not involved and who were not responsible for the breach are not liable unless there is mismanagement, which was an important cause of the bankruptcy.

d) There is a statutory limitation period of 5 years as from the time the breach of duty is discovered.

2.7 False representation to company's creditors

a) False representations to the company's creditors may give rise to director's liability based on tort. Normally speaking there will not be any criminal liability.

b) Generally speaking only the managing directors who were actually involved will be liable; however, all those managing directors who are involved are jointly and severally liable (art. 6:102 NCC).

c) The normal statute of limitations applies (5 years as from the date of discovery of the false representation).

d) There are no specific defences apart from the normal defences that apply in any tort case.

e) If the false representation is based on false annual accounts (or similar documents) a specific clause (2:249 NCC) applies and creates a liability of management vis-à-vis each and every third party that suffered damages due to these false annual accounts.

2.8 Oppressive / unfairly prejudicial conduct against creditors

a) This is not a specific reason for liability in a bankruptcy. Under certain circumstances this may constitute tort.

2.9 Conduct rendering a director unfit to be a director leading to disqualification

a) There is no legislation in the Netherlands that provides for procedures leading to general disqualification of a person to become or to be a managing director of companies. But having been a director of a bankrupt company may create difficulties for such director if he wishes to incorporate a new company within 7 years after the start of the bankruptcy.

2.10 Incurring further credit during the twilight period

a) In general, incurring further credit during the twilight period will not result in liability for the managing directors. It is, however conceivable that such transactions sometimes also constitute transactions in fraud of the creditors.

2.11 Fraudulent, dishonest, wrongful and negligent trading

a) A managing director may be held personally liable in case of fraudulent, dishonest, wrongful or negligent trading. This is a type of liability that exists generally and not specifically in (near) bankruptcy situations.

b) However, if the fraudulent, dishonest, wrongful or negligent trading was an important cause of the bankruptcy, this may constitute mismanagement and may thereby lead to liability, vis-à-vis the curator (for the entire deficit in the bankruptcy) and/or vis-à-vis the tax and social security authorities for certain taxes that have not been paid.

2.12 Preferences

a) Any transaction whereby the preferences are not being honoured may constitute a tort by the involved manager(s) vis-à-vis the creditors whose interests were harmed.

b) The liability that may arise is civil and not criminal.

c) In as far as the question individual versus joint and several liability is concerned, see above under 2.2.c

d) In as far as the defences are concerned, see under 2.6.d.

2.13 Transactions at undervalue

a) Transactions at undervalue may lead to liability of the managing directors vis-à-vis the company, because of breach of duty of a managing director (2:9 NCC).

b) It may also lead to liability based on tort vis-à-vis creditors whose interests were harmed.

c) It may finally constitute mismanagement and thereby lead to liability vis-à-vis the curator and/or the fiscal and social security authorities.

d) In as far as the question of individual versus joint and several liability is concerned, see under 2.2.c.

e) In as far as the defences are concerned, see above under 2.6.d

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

a) In addition to the formally appointed directors, a de facto managing director may be liable together with the formal managing director if there is mismanagement that is an important cause for the bankruptcy.

b) Former directors may also be liable but only in as far as the activities during the period in which they were active as director are concerned.

c) Persons knowingly dealing with a director abusing his powers, may be held liable if and to the extent that their behaviour constitutes tort.

3.2 Acts by third parties and extent of liability

a) A de facto manager may be held liable for any actions of the management in the same way a formal director may be held liable.

b) The former managing director's liability is the same as the formal managing director's, however limited to (collective or single) management actions in his active period and related to the later insolvency.

c) The liability of a person (knowingly) dealing with a director abusing his/her powers and that of third parties with knowledge of insolvency of the company, is limited to the damage resulting from the actions they were involved in.

d) There is no specific legal basis for a liability of financing banks during the twilight period.

3.3 Limited/more general liability

a) The liability of the de facto director will be more generally in relation to the entire deficit in the bankruptcy.

b) The liability of former directors will be more generally in relation to the entire deficit in the bankruptcy.

c) The liability of a person (knowingly) dealing with a director abusing his powers and the liability of third parties with knowledge of insolvency of the company and financing banks will be limited to the damage directly resulting from the specific transaction.

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 Potential heads of challenge regarding transactions with the company

a) *Transactions at an undervalue or to the detriment of creditors*

Actio Pauliana

Under the provisions of the Actio Pauliana, a legal act between the debtor company and a third party before the adjudication of bankruptcy, which is

detrimental to the creditors can be invalidated. For legal acts which the debtor company was not obligated to perform, the most important conditions are: the creditors of the debtor company must suffer damages as a result of the transaction, and each of the debtor company and the third party with whom the transaction was entered into should have been aware of the fact that the transaction would be prejudicial to the interests of the creditors. In the year preceding the formal insolvency proceeding, this awareness by both the debtor company and the third party is a legal presumption in case the value of the performance by the debtor company exceeds by far the value of the performance by the third party. For completeness sake we note that under certain – strict – conditions, legal acts which the debtor company was obligated to perform can be invalidated as well with the Actio Pauliana.

General Tort

Under the general tort provision of the NCC (article 6:162), a party who has dealt with the debtor company during the twilight period can be held liable for damages. Roughly speaking, the requirements for this liability are (i) an act or omission which infringes another person's right, violates a legal obligation or breaches a duty of care, (ii) which act can be attributed to said party, (iii) damages and (iv) said damages having been caused by the unlawful act. If the third party is held liable under the general tort provision, a judge may as compensation – instead of a judgement to pay damages – order the reversal of the legal act.

b) Extortionate credit transactions

In addition to the Actio Pauliana and general tort provisions (see under a. above), we note that extortion in general could give rise to an action for cancellation of a legal act for misuse of circumstances. Apart form the cancellation of the legal act, misuse of circumstances could also lead to an amendment of the consequence of the act.

c) Breach by directors of general/common law duties – e.g. to consider the interests of creditors (of which counterparty is on notice)
Apart from the tort provisions (see under a. above), no specific provisions apply. However, we do note that under specific circumstances, the liability of a mother company vis-à-vis the creditor of its subsidiary company has been accepted by our Supreme Court, in a case where the subsidiary company acted wrongfully vis-à-vis said creditor based on a breach of its general duty to consider the interests of its creditors, and the mother company has approved or acted instrumental to such behaviour.

d) Transactions in fraud of creditors

Apart from the Actio Pauliana and general tort provisions (see under a. above), no specific provisions apply. In respect of the general tort provision, we do note that in Netherlands jurisprudence it has been accepted that a trustee can institute an action vis-à-vis third parties based on the general tort provision on the ground that the acts of such third party have been detrimental to the (collective) creditors.

e) Preferences

Apart from the Actio Pauliana and general tort provisions (see under 1 above), no specific provisions apply.

f) Other?

None.

g) *Defences*

There are no specific defences apart from the normal defences that apply in any tort case.

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 Enforcement

a) Based on general tort, any third party can bring action against the managing directors (and/or others identified in question 3 above). This includes the *curator*, creditors, shareholders, etc.
Based on articles 2:9 NCC, a *curator* can institute legal actions vis-à-vis the directors for a breach of their breach of their duty of care vis-à-vis the company.

b) Based on articles 2:138/248 NCC, a *curator* can institute legal actions vis-à-vis the directors (and/or others identified in question 3 above) for "mismanagement".

c) Based on article 2:139/249 NCC any third party can institute legal actions vis-à-vis directors for any misrepresentation in the published (annual or interim) accounts or annual reports.

d) Finally, the Tax Collector and/or Industrial Association for social insurance may institute legal actions against directors for tax, social security and pension obligations.

e) The District Attorney (Officier van Justitie) can institute legal action vis-à-vis directors for criminal liability under the Penal Code.

f) The shareholders, the unions, the District Attorney, the curator and the company itself may start proceedings before the entrepreneurial chamber of the court of appeal in Amsterdam requesting that an investigation into the

affairs of the company take place. If from such an investigation it appears that there has been mismanagement, the court may inter alia suspend or dismiss the managers.

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 Remedies

(Question 2) Managing directors

a) Article 2:9 NCC:
If the court holds that the managing director is liable ex article 2:9 for breaching his duties vis-à-vis the company, it will order that the managing director is to pay an amount in compensation to the company equal to the damage caused by the breach of his duties.

b) Article 6:162 NCC by the trustee:
If the court holds that the managing director is liable ex article 6:162 NCC against the estate for causing a detriment to the general creditors' interest, e.g. for bringing about a transaction which can be avoided under article 42 or 47 NBA, it will order that the managing director is to pay an amount in compensation to the estate equal to the damage caused by the transaction.

c) Article 6:162 NCC by an individual creditor (I)
If the court holds that the managing director is liable ex article 6:162 NCC vis-à-vis an individual creditor, for allowing the company to enter into an agreement with such creditor, knowing that the company will neither be able to perform nor provide recourse for the damage caused thereby, while the creditor has (implicitly or explicitly) been given a positive impression of the creditworthiness of the company, the court will award damages equal to the creditor's loss compared to the situation in which he would not have entered into the agreement (or not on the same terms).

d) Article 6:162 NCC by an individual creditor (II)
If the court holds that the managing director is liable ex article 6:162 NCC vis-à-vis an individual creditor, for allowing the company to breach an agreement with such creditor, the court will award damages equal to the amount for which the creditor does not find recourse against the company.

e) Article 2:138 (248) NCC by the trustee
If the court holds that the managing director is liable ex article 2:248 NCC vis-à-vis the estate, i.e. if it can be assumed that the improper management of the managing board formed a major cause of the bankruptcy, the court may

hold him jointly and severally liable with the other directors for the entire deficit of the estate, including the costs of the court proceedings. The circumstances of the case may however lead the court to reduce the amount for which an individual director is held liable.

f) Article 2:249 NCC
If the court holds that the managing director is jointly and severally liable for misleading (yearly) accounts of the company ex article 2:249 NCC vis-à-vis persons who were actually misled and suffered damage as a result thereof, it may award the damages caused thereby.

g) Article 2:11 NCC
If the court holds that a statutory director is liable under any of the above articles, and that director is a legal entity, the director(s) of that legal entity are jointly and severally liable.

(Question 2) Supervisory directors

a) Article 2:9 NCC:
If the court holds that the supervisory director is liable ex article 2:9 for breaching his duties vis-à-vis the company, it will order that the supervisory director is to pay an amount in compensation to the company equal to the damage caused by the breach of his duties.

b) Article 2:149 (259) by the trustee
If the court holds that the supervisory director is liable ex article 2:149 (259) NCC vis-à-vis the estate, i.e. if it can be assumed that the improper supervision by the supervisory director of the management of the board formed a major cause of the bankruptcy, the court may hold him jointly and severally liable with the other managing and supervisory directors for the entire deficit of the estate, including the costs of the court proceedings. The circumstances of the case may however lead the court to reduce the amount for which an individual outside director is held liable.

c) Article 2:260 NCC
If the court holds that the supervisory director is (together with managing directors and other supervisory directors jointly and severally) liable for misleading (yearly) accounts of the company against persons who were actually misled and suffered damage as a result thereof, it may award the damage caused thereby.

(Question 3) Other persons involved with the company's affairs

a) Article 6:162 NCC by an individual creditor (I)
It is unclear whether and if so, how far, the courts will extend the liability ex article 6:162 NCC (action in tort) of a statutory director vis-à-vis an individual creditor, for allowing the company to enter into an agreement with such creditor, knowing that the company will neither be able to perform nor provide recourse for the damage caused thereby, while the creditor has (implicitly or explicitly) been given a positive impression of the creditworthiness of the company, to other persons who play a significant role in the company's affairs. It has however been decided that a parent company exerting undue

influence over its subsidiary's policy may under certain circumstances be held liable by individual creditors of the subsidiary who have entered into agreements with that subsidiary on basis of an impression of creditworthiness. In such case the court will award damages equal to the creditor's loss compared to the situation in which he would not have entered into the agreement (or not on these terms).

b) Article 6:162 NCC by an individual creditor (II)
It is unclear whether and if so, how far, the courts will extend the liability of a managing director ex article 6:162 NCC against an individual creditor, for allowing the company to breach an agreement with such creditor, to other persons who play a significant role in the company's affairs. If so, the court will award damages equal to the amount for which the creditor does not find recourse against the company.

c) Article 2:138 (248) NCC by the trustee
If the court holds that a person qualifies as a defacto director pursuant to article 2:138 (248) sub 7 and is therefore liable ex article 2:138 (248) NCC against the estate, the court may hold him jointly and severally liable with the other managing directors for the entire deficit of the estate, including the costs of the court proceedings. Again, the circumstances of the case may lead the court to reduce the amount for which such person is held liable.

(Question 4) Counterparties

a) Article 42 and 47 NBA:
If the court decides that the *curator* (or trustee in bankruptcy) was entitled to avoid the transaction or if it avoids the transaction on his request, the court will issue an order on demand of the trustee that the transferred assets be returned to the estate or any other order fit to bring the estate back into the position as if the transaction had never occurred.

b) Article 6:162 NCC by the trustee:
If the court holds that the a person is liable ex article 6:162 NCC vis-à-vis the estate for causing a detriment to the general creditors' interest, e.g. for becoming party to, bringing about or effectuating a transaction which can be avoided under article 42 or 47 NBA, it will order that that person is (jointly and severally) liable to pay an amount in compensation to the estate equal to the damage caused by the transaction.

Netherlands Criminal Code remedies

Apart from general penalties for crimes and misdemeanours, the following provisions of the Netherlands Criminal Code deserve attention:

(a) Article 342 NCr.C
The managing or supervisory director of a legal entity which has been declared bankrupt, will be punished by up to one year imprisonment or a fine of the fifth category:

1. if he co-operated in or gave approval to any act, in breach of any bylaw, which in major part caused the losses suffered by the legal entity;

2. if he, with the objective of postponing the bankruptcy while knowing that it was unavoidable, took care or approved that the legal entity obtained credit on unfavourable terms;

3. if it can be attributed to him that certain duties of the (board of the) legal entity regarding its administration have not been fulfilled or that such administration is not presented (to the trustee) in good state.

(a) Article 343 NCr.C
The managing or supervisory director of a legal entity which has been declared bankrupt, will be punished by up to six years imprisonment or a fine of the fifth category, if he for the purpose of fraudulently causing detriment to the interests of the creditors of the legal entity:

1. either fabricated obligations or failed to account for benefits, or took any thing from the estate;

2. transferred a thing from the estate without consideration or evidently below value;

3. in bankruptcy or on a moment on which he knew that bankruptcy was inevitable, rendered an undue advantage to a creditor in any way;

4. did not fulfil his duties with regard to the maintenance of the administration of the legal entity pursuant to certain specific statutory provisions and with regard to the preservation and presentation of such administration (to the trustee) in good state.

(b) Article 347 NCr.C
The inside or outside director of a legal entity who, outside the scope of article 342 NCr.C, took part in or approved any act, in breach of any bylaw, to the substantial detriment of the legal entity, will be punished by a fine of the fifth category.

QUESTION 7

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7. Duty to co-operate

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

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

a) Article 105 NBA prescribes that the bankrupt person is obliged to appear before the supervisory judge ("rechter-commissaris"), the *curator* and the creditors´ committee and to give any information they may want. NBA these obligations apply similarly to managing directors of bankrupt companies, to former managing directors of bankrupt companies and to managing directors of companies that are itself managers of bankrupt companies.

7.2 Applicable human rights laws

a) The provisions of the European Convention of Human Rights apply.

QUESTION 8

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8. Appeals and limitation periods

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

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

8.1 Appeals and limitations

a) In general claims for damages are subject to a statutory limitation period of 5 years which period starts running when the injured person (i) knows about the losses and (ii) knows who is liable. This rule also applies e.g. to trustees in bankruptcy wishing to claim the deficit in the bankruptcy on the basis that the bankruptcy was (for an important part) caused by mismanagement (in the 3 year period prior to the bankruptcy). Avoidance claims are subject to a statutory limitation period of three years.

b) Except in cases of monetary insignificant claims, an appeal is available from decisions of the lower courts in cases as described in this document.

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 Foreign Corporations

a) The legal provisions and procedures above apply also to foreign corporations and companies except that (i) claims under Netherlands law by the *curator*/trustee in bankruptcy based on mismanagement which was an important cause of the bankruptcy are only allowed with respect to foreign entities which are subject to Netherlands company tax and that (ii) claims for breach of duty vis-à-vis the company are governed by the law of incorporation. (See further; the Act on the conflicts of law for corporations ("Wet Conflictenrecht Corporaties") article 5).

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 Liability insurance

a) Director's liability insurance is available and in fact rather common in the Netherlands.

b) It provides a reasonable protection against possible liabilities. "Reasonable", because the covered amounts are often not sufficient. In practice, however, this is not as big a problem as it may seem because the court may decide to limit the liability to the covered amounts and – also for that reason – very often settlements are made directly between the insurer and the claiming parties and have as a starting point not the possible total liability of the managing director but the maximum covered amount.

c) The insurance does normally not provide for coverage against the consequences of fraudulent behaviour of the director himself.

QUESTION 11

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

11.1 Extra credit

a) Further (extra) credit can only be incurred if there is not a reasonable perspective, that such obligation cannot or will not be met, or, if there is such perspective, the bank knowingly takes the risk of not being repaid. However, even if there is a perspective that the obligations resulting from incurring further credit can or will be met, the incurring of further finance may still be an improper action which may result in personal liability of the director if there is no reasonable perspective for the company which justifies that assets of the company, which form the current creditors lasting security, are being sacrificed.

b) An unconnected third party can, generally, rely on the validity of transactions entered into with a company in the twilight period. However, if the transaction supplies the third party with a performance which he had had no right to before and he knew or could have known that the company was being disadvantaged, the transaction might be affected.

Abbreviations:

NBA : Netherlands Bankruptcy Act (Faillissementswet)
NCC : Netherlands Civil Code (Burgerlijk Wetboek)
TCA : Tax Collection Act (Invorderingswet)
LCSP : Law on the co-ordination of social security insurances (Coördinatiewet Sociale Verzekeringen)
NCr.C: Netherlands Criminal Code (Wetboek van Strafrecht).

NEW ZEALAND

QUESTION 1

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

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

1.1 Overview

Transactions vulnerable to attack

1.1.1 The *Companies Act 1993* recognises that certain transactions entered into before the commencement of formal insolvency proceedings (liquidation of the company) could have the effect of unfairly advantaging one creditor at the expense of the company and its creditors in general. The Act[1] therefore contains provisions in sections 292 – 299 enabling a liquidator of the company to set aside certain transactions having preferential effect, voidable charges, transactions at an undervalue and transactions which appear to give an advantage to persons who have a special relationship with the company. A full description of these types of transaction can be found in Question 4.

The start and duration of the "twilight period' depends on the nature of the transaction and the identity of the parties to it.

1.1.2 The vulnerability periods for transactions entered into by a company before the commencement of formal insolvency proceedings (liquidation) which are vulnerable to attack are:

(a) Transactions having preferential effect (s.292) – 2 years

(b) Voidable charges (s.293) – 1 year

(c) Transactions at an undervalue (s.297) – 1 year

(d) Transactions for inadequate or excessive consideration with directors and certain related parties (s.298) – 3 years

(e) Securities and charges issued by the company in favour of directors and certain related parties (s.299) – no time limit.

1.1.3 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:

[1] References to the Act and all section references in this paper are to the Companies Act 1993, unless otherwise stated.

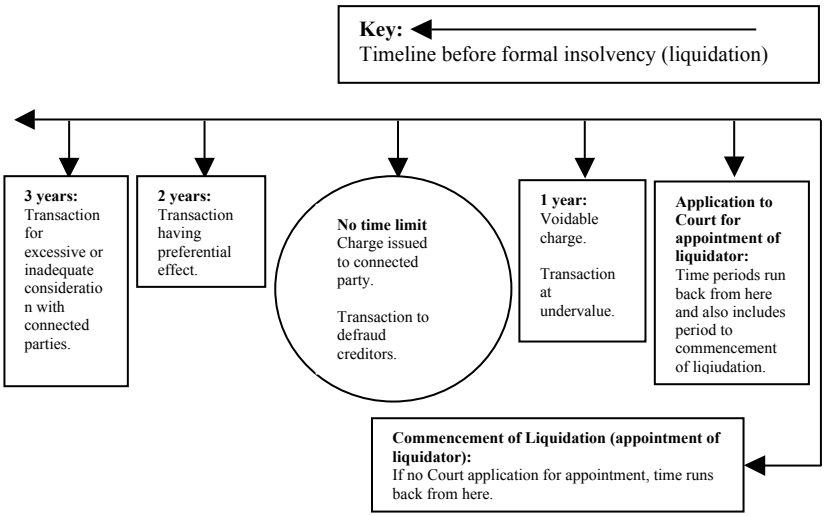
(a) the liquidator is appointed by the Court; or

(b) an application is made to the Court to put a company into liquidation and after the making of the application a liquidator is appointed by resolution of the shareholders of the company,

the period runs back from the date on which the application to the Court was made and **also** includes the period between the date on which the application was made and the date on which the liquidator is appointed.

1.1.4 The Property Law Act 1952 also contains a provision which has the effect of avoiding any transfer of property with intent to defraud creditors. The transaction is voidable at the instance of the person prejudiced. There is no time limit. However the transaction cannot be avoided if the property was transferred to a purchaser in good faith and for value who had no notice of the intention to defraud creditors.[2]

1.1.5 The following time line shows in graphic form the periods in respect of which certain types of transaction are vulnerable.



[2] Section 60, Property Law Act 1952

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:

[3] Section 136

(i) It applies to directors, “de facto directors”, "shadow directors" and “deemed directors” [4] of a company;

(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, 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 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.

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[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.

[5] *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 CA

(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

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

[6] Section 135

[7] See paragraphs 3.2.1 - 3.2.12 below for a full explanation of these terms. For current purposes a "de-facto" director is someone who may not have been formerly appointed as a director but who acts in the same way as a director or is held out as such. A "shadow director" is someone in accordance with whose directions or instructions the directors of the company are accustomed to act. It will thus cover the "puppet master" who, for whatever reason, does not wish to appear on the face of the record as a director of the company but who in fact "pulls the strings" and tells the directors what to do. This would also include parent companies who in effect decide what their subsidiaries do.

- 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.

The fact that a director has no knowledge of the company's affairs will almost certainly not excuse a breach of duty.

While a non-executive director may not be expected to have the same involvement in the company as an executive director (*AWA Limited v Daniels* (1992) 10 ACLC 993) it is thought that when it comes to responsibility for what has been done by the company, the same standards will be applied to both types of directors.

Delegation of Powers

A director may have a defence where the board of directors of the company has delegated relevant powers (including powers to enter into contracts and incur obligations) to a committee of directors, a director or an employee of the company. A board is able to delegate most of its powers (s.130).

A board that delegates a power is not responsible for the exercise of the power by the delegate if the board:

- believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise it in conformity with the duties imposed on directors by the Act and the company's constitution; and
- the board has monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

Where a power of the board has been properly delegated, the delegate will be regarded as a director for the purpose of duties imposed by the Act (s.126).

2.4 Liability to repay distributions made to shareholders[8]

(a) A board of a company may not authorise a distribution to shareholders unless the board is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the statutory solvency test.[9]

Directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion.

A distribution made to a shareholder at a time when the company did not, immediately after the distribution, satisfy the solvency test may in certain circumstances be recovered from the shareholder. To the extent that a distribution is not able to be recovered from the shareholder (because the shareholder has no obligation to repay it, because the shareholder has insufficient assets or for any other reason), any director who failed to take reasonable steps to ensure the correct procedures for authorising distributions were followed, or who signed the solvency certificate when there were no reasonable grounds for believing at that time that the company would satisfy the solvency test, will be liable to the company to repay the distribution.

(b) (i) The liability is civil and in part criminal (a director commits an offence if he or she voted in favour of a distribution and fails to sign the solvency certificate – s.52(5)).

(ii) Civil liability is limited to repayment of so much of the distribution as cannot be recovered from shareholders. However, where a company could have satisfied the solvency test by making a distribution of a lesser amount, the Court in an action against a director or shareholder has the discretion to permit the shareholder to retain (or relieve the director from liability in respect of) an amount equal to the value of any distribution that could properly have been made.

(iii) Liability of the relevant directors concerned will be joint.

(iv) There is no specified period – the critical element is whether immediately after the distribution the solvency test was satisfied.

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[8] Section 56 - A distribution to shareholders is defined in section 2(1) as:
(a) the direct or indirect transfer of money or property (other than the company's own shares) to or for the benefit of the shareholder; or
(b) the incurring of a debt to or for the benefit of the shareholder,
in relation to shares held by that shareholder.

[9] A company satisfies the solvency test if:
(a) the company is able to pay its debts as they become due in the normal course of business; and
(b) the value of the company's assets is greater than the value of its liabilities including contingent liabilities (section 4).

(v) A director has a defence if he or she can show that they took reasonable steps to ensure that the statutory procedure which is a prerequisite to authorising a dividend was followed, or that there were reasonable grounds to believe the company would satisfy the solvency test.

2.5 Liability if proper accounting records not kept[10]

(a) The board of directors of a company has statutory duties to cause adequate accounting records to be kept that correctly record and explain the transactions of the company and that will at any time enable the financial position of the company to be determined with reasonable accuracy. The board also has obligations to ensure that financial statements of the company comply with provisions of the Financial Reporting Act 1993 and to keep sufficient accounting records to enable the financial statements of the company to be readily and properly audited (section 194)

(b) (i) The liability in relation to the duty is both criminal and civil. If the board fails to comply every director commits an offence.

(ii) If a company that is in liquidation is insolvent and there has been failure to

(iii) comply with these duties, and the Court considers that the failure to comply:

- contributed to the company's inability to pay all its debts; or
- has resulted in substantial uncertainty as to the assets and liabilities of the company; or
- has substantially impeded the orderly liquidation; or
- for any other reason it is proper to make a declaration,

the Court on the application of a liquidator, may declare that any one or more of the directors or former directors are personally responsible for all or any part of the debts and other liabilities of the company. The liability may be joint or proportional.

(iv) There is no specified period.

(v) In relation to the civil liability, the director has a defence if he or she can satisfy the Court that he or she:

- took all reasonable steps to secure compliance by the company with the provision; or
- had reasonable grounds to believe and did believe that a competent and reliable person was charged with the duty, and was in a position to discharge the duty.

In relation to criminal liability a director charged with an offence concerning a duty imposed on the board of a company has a defence if the director proves that:

[10] Sections 194 and 300

- he or she took all reasonable and proper steps to ensure that the board complied with the duty; or
- the board took all reasonable and proper steps to ensure that the duty would be complied with; or
- in the circumstances he or she could not reasonably have been expected to take steps to ensure that the board complied with the duty (s.376).

2.6 Wrongdoing[11]

(a) (i) This liability applies to directors, "de facto directors", "shadow directors" and certain types of "deemed director".

(ii) A past or present director of the company who has misapplied or retained, or become liable or accountable for, any money or other property of the company, or has been guilty of negligence, default or breach of any duty or trust in relation to the company, will incur liability.

(b) (i) The liability under the section (s.301) is civil.

(ii) The Court has a discretion to order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the court sees fit, or to contribute such sum to the company's assets by way of compensation in respect of the negligence, default or breach of duty as the court thinks fit.

(iii) The Court has wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability. It may also make some or all of the directors jointly and severally liable for the compensation – in this case directors will enjoy rights of contribution from other directors also found responsible for the same loss.

(iv) Apart from Limitation Act 1950 considerations, there is no time period within which the impugned act must have occurred in order for liability to attach.

(v) There are no specific statutory defences to an action against directors under these heads. The Court however has considerable discretion as to quantum of any order against the director.

2.7 Liability in relation to other statutory duties under the Act

Liability to the company or to shareholders?

One of the aims of the Companies Act 1993 was to make the nature and scope of directors' duties more generally accessible. The Act therefore contains in sections 131 – 149 a codification of the duties previously found in the general law. It appears that these statutory duties are intended to replace all duties at general

[11]Section 301

law, but a court has yet to confirm this. The statutory duties in sections 131 – 149 are duties of a fiduciary nature which accompany the office of director.

Duties owed to the company:[12] include

- to act in good faith in the best interests of the company [13](s.131).
- to exercise powers for a proper purpose (s.133)
- not to trade recklessly (s.135) - see paragraph 2.2 above
- not to agree to certain obligations (s.136) – see paragraph 2.1 above
- to exercise care (s.137) – see below
- duties relating to disclosure of company information and the use of that information (s.145)

Duties owed to shareholders[14] include:

- to disclose interests and dealings in the company's shares (ss.140 & 148)

Duties owed to both company and shareholders include the duty to comply with the Act and the company's constitution (s.134).

Directors also have many administrative duties under the Act, and additional duties may be imposed by the constitution of the company or by a specific contract with a director.

Liability to creditors?

Directors are not liable to creditors as fiduciaries, or for negligence in the management of the company. Creditors therefore are not entitled to interfere in the company's affairs while it remains solvent.

However, under the general law, where a company is insolvent directors are obliged to take creditors interests into account because it is the creditors' rather than the shareholders' money at risk. (*Nicholson v Permakraft (NZ) Limited* [1985] 1 NZLR 242, *Hilton International Limited v Hilton* [1989] 1 NZLR 442). This rule is also said to apply where there is a "real risk" of insolvency. The Companies Act 1993 imposes on directors no express duty to creditors. New Zealand Courts are likely to follow English and Australian Courts which have reaffirmed there is no fiduciary duty to creditors, and that the statutory duties require enforcement under the statutory scheme. However, where the company is insolvent or near insolvency, shareholders are unable to ratify breaches by directors of duties owed to the company such as the duty not to permit insolvent trading and not to trade recklessly (*Ukon Line Limited of Korea* [1998] 2 BCLC 485, and *Spies v The Queen* [2000] 8 HCA 43).

[12] Section 169
[13] In certain circumstances the constitution of a subsidiary may permit, the directors to act in the best interests of the holding company if the other shareholders consent, and if the constitution of a joint venture company permits, directors of joint ventures may act in the best interests of the shareholder that appointed them.
[14] Section 169

The duty to exercise care (section 137)

The standard of care that applies to a director when carrying out his or her duties is the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation:

- the nature of the company;
- the nature of the decision; and
- the position of the director and the nature of the responsibilities undertaken by him or her.

2.8 Carrying on business fraudulently[15]

(a) A director (or any other person) who is knowingly a party to a company carrying on business with intent to defraud creditors of the company or any other person or for a fraudulent purpose, commits an offence.

Also, every director commits an offence who:

(i) by false pretences or other fraud induces a person to give credit to the company; or

(ii) with intent to defraud creditors of the company:

- gives, transfers or causes a charge to be given on property of the company; or
- causes property to be given or transferred to any person; or
- caused or was a party to execution being levied against property of the company.

(b) (i) Liability is criminal, but may also be civil (see paragraph 2.6).

(ii) A person guilty of these offences is liable to imprisonment or a fine, and is automatically prohibited from being a director of or managing a company for 5 years without leave of the Court (s.382).

(iii) The gravity of the wrongdoing will be reflected in the length of imprisonment or the 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) 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.

[15] Section 380

2.9 Avoidance or obstruction[16]

(a) A director of a company (or any other person) commits an offence if he or she:

(i) Leaves New Zealand with the intention of:
- avoiding payment of money due to the company; or
- avoiding examination in relation to the affairs of the company; or
- avoiding compliance with an order of the Court, or some other statutory obligation in relation to the liquidation and affairs of the company

(ii) conceals or removes property of the company with the intention of preventing or delaying the liquidator taking custody or control of it; or

(iii) destroys, conceals or removes records or other documents of the company.

(b) (i) Liability is criminal (there may also be civil liability – refer paragraph 2.6) and the answers to 2.8 (b) (ii) and (iii) will apply – except that there is no automatic prohibition from being a director or manager.

(iv) The acts in question must have occurred either after the company has gone into liquidation or after an application has been made to the Court for an order that the company be put into liquidation.

2.10 Failure to identify and deliver property to a liquidator[17]

(a) A present or former director of a company in liquidation commits an offence if he or she:

(i) fails to promptly give the liquidator details of property of the company in his or her possession or under his or her control; or

(ii) fails to, at the liquidators request, deliver property to the liquidator or as directed, or dispose of the property as directed.

(b) (i) Liability is criminal (there may also be civil liability – refer paragraph 2.6) and the answers to 2.8 (b) (ii) and (iii) will apply – except that there is no automatic prohibition from being a director or manager.

(iv) 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:

[16] Section 273
[17] Section 274

- 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 is 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.

2.12 Liability of directors under the Fair Trading Act 1986

(a) Sometimes directors make untrue or misleading representations to creditors about the financial position of the company in an endeavour to induce those creditors to make further supply at a time when the company is insolvent. If those creditors subsequently suffer loss, the directors may be personally liable to creditors under the Fair Trading Act 1986.

The actions of the directors can constitute misleading or deceptive conduct in trade. A number of recent New Zealand Court decisions have held that where the directors are the source of the information or misrepresentation and not a mere conduit of information, and were responsible for the manner in which the company's business was conducted with suppliers and other creditors, those directors can be held personally liable for the representations, irrespective of whether the representations were made on behalf of the company rather than in a personal capacity. See for example *Hill Country Beef NZ Limited* v *Sharplin* (High Court, Napier CP5/95, 28.3.96) and *Borrie* v *Specialist Livestock Imports Limited & Others* (High Court, Auckland CP381/97, 4.6.00).

(b) (i) The liability is civil;

(ii) The director making the representation will be personally liable for the loss suffered by the particular creditor as a result of the misrepresentation;

(iii) There is no specified period, but generally the company will need to be in financial difficulties.

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

2.13.1 The Registrar of Companies can prohibit any person who within the previous five years has been a director of, or concerned in or taken part in the management of, a company which becomes insolvent or which enters into a compromise or arrangement with its creditors, from being a director or promoter of a company (or being concerned in, or taking part, whether directly or indirectly in the management of, a company) for a period up to 5 years (s.385).

2.13.2 If a person becomes involved in the management of a company during the prohibition period, that person will automatically be personally liable to a liquidator of the company for every unpaid debt incurred by the company (and to a creditor of the company for a debt to that creditor incurred by the company), while the person was so acting. The person also commits an offence and on conviction is liable to a substantial fine or prison term (ss.385 & 386).

2.13.3 A person who has done any of the following things can be disqualified by the Court from being a director or promoter of, or in any way, whether directly or indirectly, being concerned in or taking part in the management of, a company for a period of up to 10 years, without leave of the court:

(a) While a director of a company and whether convicted or not

- persistently failed to comply with the Act, or the Securities Act 1978 (dealing with the issue of securities to the public) or, where the company has failed to comply, persistently failed to take all reasonable steps to obtain such compliance; or
- been guilty of fraud in relation to the company or of a breach of duty to the company, or a shareholder; or
- acted in a reckless or incompetent manner in the performance of his or her duties; or
- committed an offence under the Act

(b) been convicted of an offence in connection with the promotion, formation or management of a company, or a crime involving dishonesty.

(c) is held by a Court to be guilty of insider trading of a company's shares.

Applications to the Court for disqualifying a person can be made by the Registrar of Companies, the liquidator of the company or a creditor of the company (s.383).

2.13.4 Directors (and others) convicted of certain offences, or who have been found guilty of insider trading, are automatically disqualified from being directors of companies for a period of 5 years unless they obtain the leave of the Court (s.382).

The persons affected are those who:

- have been convicted on indictment of any offence in connection with the promotion, formation, or management of a company; or
- have been convicted of certain offences under the Act (those referred to in paragraphs 2.8 & 2.11 above), or any crime involving dishonesty; or
- are held by a Court to be guilty of insider trading of a company's shares.

2.13.5 Failure to seek leave of the Court constitutes an offence and exposes a director to personal liability for unpaid debts incurred by the company while the person acted without leave (s.382 and 384).

QUESTION 3

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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?

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

3.1 Introduction

3.1.1 Subject to the particular act or offence in question, New Zealand law may impose liability on a potentially wide variety of persons who have been involved in the management of a company in some way during the twilight period.

3.1.2 Although the management of a company's affairs is primarily undertaken by its directors, New Zealand law has an extended definition of this term[18] which is capable of including a variety of persons who, while not formally appointed as directors, may have played a role in the company's management during the

[18] Section 126

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 an extremely wide definition of “director”. Some categories of the definition apply only for the purposes of certain sections of the Act. Although the definition is not exhaustive of the meaning of the term “director”, because of the comprehensive nature of the definition there does not seem much scope for including any other persons. Any person who is responsible for management decisions of the company will fall within one or more legs of the definition. Receivers of companies (appointed by secured creditors or by the Court) are excluded from the definition.

A brief description of the categories of “director” follows.

De facto directors

3.2.2 A “de facto” director is one who acts as a director and is treated as such by the rest of the board, even though he or she may never have been formally appointed a director or there is a defect in the technicalities of his or her appointment (for example he or she was appointed at a board meeting at which a quorum was not present).

3.2.3 "Director" is defined in section 126(a) of the Act to include any person occupying the position of director, by whatever name called. Thus, if someone were to be called an "observer" on the board but in fact took director-type decisions, the court may be prepared to conclude that that person is a de facto director.

3.2.4 De facto directors owe the same duties to the company as directors who have been formally appointed.

Shadow directors

3.2.5 The term "shadow director" is generally used to describe a person in accordance with whose directions or instructions a director, or the board of directors, of a company may be required or are accustomed to act, and a person who exercises or who is entitled to exercise or who controls or is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board (s.126(1)(b)).

3.2.6 There are a number of elements to note in the definition:

Person	can mean an individual or a corporation
Directions or instructions	these are clearly more than mere suggestions but may include non-professional advice in certain circumstances
Accustomed to act	there must be a pattern to the directions or instructions and occasional directions will not make someone a shadow director. However, again, the point at which conduct becomes habitual will depend upon the facts of a particular case

In practice, what conduct makes someone a shadow director?

3.2.7 In each case regard must be had to the frequency of the advice or instructions (whether over the running of the business as a whole or merely on specific areas) and whether such advice was usually acted upon (whether or not the directors have expressly or impliedly surrendered their discretion), so that it may be said that the third party in question exerted a real influence over the affairs of the company.

3.2.8 There have been no reported New Zealand Court decisions on shadow directors. However, it is probable that New Zealand Courts would follow or at least be influenced by the decisions of Australian and English Courts – the legislative provisions in both those countries are similar to those in New Zealand.

Deemed Directors

3.2.9 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)).

3.2.10 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

3.2.11 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

3.2.12 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

3.2.13 A person acting as a director or taking part in the management of a company while disqualified from doing so may become personally liable for the company's debts (ss. 384 & 386).

3.3 Actions for which liability may attach to de facto, shadow or deemed directors and other persons not formally appointed as directors

Offence/activity	Persons liable	Extent of liability
Insolvent and Reckless Trading and other statutory duties (ss.131 – 141)	Past director and past and present de facto, shadow and certain deemed directors, during the relevant period.	Same as for director
Fraudulent trading (s.380 and s.373(4)(f))	Any person who was knowingly a party to the carrying on of the business with intent to defraud creditors or others or for a fraudulent purpose (this will include persons dealing with the company who receive property with knowledge of the fraud)	Same as for director
Failure to keep proper accounting records (ss 194 and 300)	Past directors for the relevant period	Same as for director
Leaving New Zealand or concealing destroying or removing property (ss.273 and s.373(3)(a))	Any person	Same as for director
Failure to identify or deliver company property (ss.274 & 373(3)(a))	Past director and past or present employee	Same as for director
Wrongdoing – negligence or default or breach of duty (s.301)	Any past director; past or present de facto, shadow and certain deemed directors; liquidator; manager; receiver; any person involved in the formation or promotion of the company	Same as for director
Acting as a director or taking part in management of the company when disqualified (s.384 and s.386)	Any person	All debts incurred by the company during that period.

3.4 Other third parties who may be held liable to the company or its liquidator

3.4.1 Liquidators and receivers may be found liable for negligence, default or breach of duty owed to the company (s.301).

3.4.2 Third parties who receive property as a result of a transaction at undervalue, a transaction having preferential effect or (if that party has the requisite knowledge

or is a volunteer) as a result of a transaction defrauding creditors, will be liable to either return such property or provide such compensation as the court may order.

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

Offence/activity	**Persons liable**	**Extent of liability**
Transaction at undervalue (s.297)	Recipient of property.	Pay compensation to the company
Transactions having preferential effect (ss. 292 & 293)	Recipient of preference or charge	Return of property received or removal of specific benefit received or payment of an amount fairly representing benefit received
Transactions for inadequate or excessive consideration with connected parties. (s.298)	Other party to transaction	Pay compensation to the company
Voidable charges (s.293) and charges issued to connected parties(s.299)	Recipient of charge	Setting aside of charge
Transaction defrauding creditors (s.60 Property Law Act 1952)	Recipient of property (if knowledge of fraud or volunteer)	Return of property received (or compensation if property disposed of)
Knowingly assisting or receiving property or assets in breach of duty	Any person with the requisite degree of "knowledge" who knowingly assists in a breach of duty owed by a person to a company or knowingly receives property from a breach of duty owed to the company	Where requisite knowledge and other applicable conditions are satisfied a person may be held to be a constructive trustee of the property and required to return such property or pay compensation equal to the loss caused. A director's liability arises directly as a result of the breach of duty. Knowledge or dishonesty not required

QUESTION 4

4. Counterparties dealing with the company during the twilight period

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

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

4.1 Summary of heads of challenge

4.1.1 Brief details of those types of transaction entered into by a company before the commencement of formal insolvency proceedings which are vulnerable to attack are transactions:

(a) which are at an undervalue;

(b) which have preferential effect;

(c) which constitute voidable charges;

(d) for inadequate or excessive consideration with directors or other related parties;

(e) which are securities or charges issued by the company in favour of directors or other related parties;

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

(g) defrauding the company;

or which involve the following elements:

(h) onerous property;

(i) unregistered charges.

We look briefly at each head of challenge in turn.

4.2 Transactions at an undervalue (section 297)

4.2.1 A transaction is at undervalue if the value received by the company was less than the value provided by the company and, when the transaction was entered into, the company:

(i) was unable to pay its due debts; or

(ii) was engaged, or about to engage, in business for which its financial resources were unreasonably small; or

(iii) incurred an obligation knowing that the company would not be able to perform it; or

(iv) became unable to pay its due debts as a result of the transaction.

4.2.2 If the company is put into liquidation, a liquidator can recover from the counterparty to the transaction the amount by which the value of the consideration or benefit provided by the company exceeded the value of the consideration or benefit received by the company. The liquidator can only do this in respect of transactions:

(i) where the liquidator can establish the counterparty to the transaction knew or ought to have known of the relevant factor referred to in paragraph 4.2.1; and

(ii) the company entered into within a year before liquidation (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of this vulnerability period).

4.2.3 "Transaction" is defined in section 297 as including the giving of a guarantee by the company. It is thought that the New Zealand Courts will also use the definition of transaction contained in the section dealing with transactions having preferential effect (refer paragraph 4.3.4).

4.2.4 However, the term "transaction" does not include bilateral netting (set-off) agreements, or certain multilateral netting agreements which are subject to the rules of a recognised clearing house, entered into by the company – except to the extent that the effect of entering into the netting agreement is to reduce any amount that was owing by or to the company at the time the company entered into the agreement (s.310G).

4.2.5 A guarantee by a company to a bank of the liabilities of a parent or sister company might be a classic example of an undervalue transaction - if, say, the idea is simply to use the company to benefit its financially troubled parent or sister company. In relation to guarantees, there is no authority on the test to apply to ascertain the value provided by the guarantor and provided by the bank.

4.2.6 In practice, liquidators have found it difficult to use section 297 to set aside transactions. This is because the section focuses on whether the counterparty to the transaction knew or ought to have known of the company's precarious financial position at the time of the transaction – the onus is on the liquidator to establish this.

4.3 Transactions having preferential effect (section 292)

4.3.1 A transaction having preferential effect is a transaction entered into by the company at a time when it was unable to pay its due debts, and which enables another person to receive more towards satisfaction of the debt than the person

would otherwise have received or be likely to have received in the liquidation – unless the transaction took place in the ordinary course of business.

4.3.2 If the company is put into liquidation, a liquidator can recover from the counterparty to the transaction an amount which fairly represents the benefits received by the party (for example, if the transaction was the payment of a debt, an amount equivalent to the payment), or in some cases property which was transferred to that party as part of the transaction. The liquidator can only do this in respect of transactions the company entered into within two years before liquidation (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of this vulnerability period).

4.3.3 If the transaction was entered into within six months before liquidation, there is a statutory presumption that the transaction was made at a time when the company was unable to pay its due debts, and that the transaction was not in the ordinary course of business. The onus of rebutting these presumptions is on the counterparty to the transaction. That party does not have to rebut both presumptions – rebuttal of either will mean the transaction cannot be avoided by the liquidator.

4.3.4 Transaction" is widely defined. It includes the incurring of any obligation by the company, the giving of a security or charge over the property of the company, and the payment of money by the company under a judgment or order of the Court. The transaction must be a transaction of the company. The New Zealand Courts have held that the transaction must be with a creditor of the company.

4.3.5 However, the term "transaction" does not include bilateral netting (set-off) agreements, or certain multilateral netting agreements which are subject to the rules of a recognised clearing house, entered into by the company – except to the extent that the effect of entering into the netting agreement is to reduce any amount that was owing by or to the company at the time the company entered into the agreement (s.310G).

4.3.6 The meaning of the expression "the ordinary course of business" has been the subject of a considerable amount of judicial interpretation (some of which has been in conflict). Factors which generally indicate that a transaction is outside the ordinary course of business include:

(1) Payment is atypically prompt or large compared with the established patterns;

(2) The conduct of the company is suggestive of a response to abnormal financial conditions;

(3) Putting pressure on the company to pay (indicates abnormal circumstances);

(4) The creditor has departed from its normal practice of recovering debt;

(5) Lump sum payments or the use of postdated cheques (where this is not usual practice).

4.3.7 For a transaction to be within the ordinary course of business, the creditor or liquidator (as the case may be) needs to show that there was nothing abnormal –

nothing out of the ordinary – about the transaction in the commercial context in which it took place. The transaction must be such that in its actual setting it would be viewed by an objective observer as having taken place in the ordinary course of business. While there can be reference to business practice in the commercial world in general, the focus must still be the ordinary operational activities of businesses as going concerns, not responses to abnormal financial difficulty. (*Countrywide Banking Corporation Limited* v *Dean* [1998] 1 NZLR 385 (Privy Council); *Re Excel Freight Limited (In Liquidation)* (Court of Appeal 21 February 2001).

4.3.8 Intention on the part of the company to prefer the counterparty is irrelevant unless that intent was actually known to the other party. If known, the intent is only one of the factors to be taken into account (s.292(4)).

4.3.9 Generally speaking, where a liquidator has recovered any amount from a counterparty in relation to a transaction having preferential effect, the counterparty is able to prove as a creditor in the liquidation for an amount equivalent to the sum or value of the property the liquidator recovered.

4.4 Voidable Charges (section 293)

4.4.1 Any charge given by the company is voidable against the liquidator of the company if given within 1 year before liquidation (see paragraphs 1.1.2 & 1.1.3) unless:

(1) (and only to the extent that) the charge secures money actually advanced or paid, or the actual price or value of property sold or supplied to the company, or any other valuable consideration given in good faith by the recipient of the charge at the time of, or at any time after, the giving of the charge[19]; or

(2) immediately after the charge was given the company was able to pay its due debts; or

(3) the charge is in substitution for a charge given before the 1 year period (but only to the extent that the amount secured does not exceed the amount secured by the previous charge and the value of the property charged does not exceed the value of the property subject to the previous charge)

4.4.2 If the charge was given within six months before liquidation, there is a statutory presumption that immediately after the charge was given the company was unable to pay its due debts.

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

[19] A charge given to secure the unpaid purchase price of property, whether or not the charge is given over that property, will be valid so long as it is executed not later than 30 days after the sale of the property.

being appropriated as far as may be necessary towards repayment of money actually advanced or paid (or payment of the actual price or value of property sold) by the grantee to the company on or after the giving of the charge.

4.4.4 Case law has made it clear that simply forbearing to sue for past debts will not be valuable consideration given in good faith by the chargeholder for purposes of this section, unless the forbearance can be shown to have some reasonable value or worth to the debtor (*Meo & Anor* v *The Official Assignee* (1987) 3 NZCLC 100,206, Court of Appeal).

4.5 Transactions for inadequate or excessive consideration with directors or related parties (section 298)

4.5.1 Where a company which subsequently goes into liquidation has acquired any business, property or services from a director or other specified related parties, the liquidator can recover from those parties the amount by which the value of the consideration given by the company exceeded the value of the business, property or services received. Also, where the company has disposed of a business or property or provided services or issued shares to directors or specified related parties, the liquidator can recover from those parties any amount by which the value of the items provided exceeded the consideration received by the company.

4.5.2 The liquidator can only do this in respect of transactions the company entered into within a period of three years before liquidation (refer paragraphs 1.1.2 and 1.1.3 for a full explanation of this vulnerability period).

4.5.3 There is no need to establish whether the company was insolvent before or as a result of the transaction.

4.5.4 The categories of related parties from whom recovery is possible are extensive. They include a nominee or relative or a trustee for a director, a person or relative of a person who at the time had control of the company, related companies and companies controlled by a director of the company or a nominee, relative or trustee of a director.

4.6 Securities and charges issued by the company in favour of directors or related parties (section 299)

4.6.1 Where a company goes into liquidation, a liquidator can apply to the Court to have a security or charge created by the company in favour of a director or other specified related parties set aside. The categories of related parties under this section are the same as under section 298 (see paragraph 4.5.4).

4.6.2 The Court can order a security or charge to be set aside if it considers it just and equitable to do so, having regard to the circumstances in which the security or charge was created, the conduct of the other party in relation to the affairs of the company, and any other relevant circumstances.

4.6.3 There is no need to establish whether the company was insolvent before the security or charge was issued. There is no specified time period.

4.6.4 If the security or charge is set aside, the related party will remain a creditor of the company for the amount owing under the security or charge.

4.6.5 This provision gives the liquidator, through the Court, the ability to have securities in favour of related parties set aside which cannot be set aside under section 292 (transactions having preferential effect – see Section 4.3 of this paper) or section 293 (voidable charges – see Section 4.4 of this paper). Although there have been no reported New Zealand decisions on this section, it is thought that a Court would be slow to set aside a security if it had been issued in respect of a bona fide commercial transaction with no intention of defeating creditors..

4.7 Defences available to a counter-party (s.296(3))

4.7.1 Even though a transaction may be a transaction at an undervalue, a transaction having preferential effect or a type of transaction referred to in Sections 4.4 – 4.6 of this paper, the Courts may deny recovery by the liquidator of property or its equivalent value from the counterparty, in whole or in part, if:

(1) The person from whom recovery is sought received the property in good faith and has altered his or her position in the reasonably held belief that the transfer to that person was validly made and would not be set aside; and

(2) In the opinion of the Court it is inequitable to order recovery or recovery in full.

4.7.2 The test of good faith appears to be one of simple honesty (*Re Excel Freight Limited (In Liquidation)* (1999) 8 NZCLC 261,827). An awareness of financial difficulty of the company is not in itself sufficient to give rise to a conclusion that any actions were not taken in good faith (*Re Island Bay Masonry Limited (In Liquidation)* (1998) 8 NZCLC 261,751).

4.7.3 To alter position, a counterparty must have deliberately taken or omitted some action in reliance on the apparent validity of the transaction. Examples of alteration of position would be to continue to supply and provide further credit.

4.7.4 The Court has considerable discretion about whether to deny the liquidator recovery. The concept of inequity carries the connotation of unfair or unjust. The Court will look at the overall circumstances and do what the justice of the case requires, having regard to the objective of the insolvency regime to ensure that creditors of an insolvent company of the same class are treated equally.

4.8 Breach by directors of general/common law duties

4.8.1 If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general common law duty to put the company's interests first. Where the counterparty has knowledge of this, there may be circumstances where there are proprietary or

restitutionary rights to recover the property. These are rights under the general law and whilst not dependent upon insolvency as such, they are more likely to be examined and/or exercised after a formal insolvency event.[20]

4.9 Transactions with the intent to defraud creditors[21]

4.9.1 Where a company transfers property with intent to defraud creditors, that transfer is voidable at the instance of the person prejudiced.

4.9.2 There is no statutory time limit.

4.9.3 If the property is transferred to a purchaser who purchases for value in good faith and at the time of the transfer without notice of the intention to defraud creditors, the property cannot be recovered.

4.10 Disclaimer of onerous property (section 269)

4.10.1 When a company is in liquidation, the liquidator may disclaim any onerous property even though he or she has taken possession of it, tried to sell it, or otherwise exercised rights of ownership in respect of it. The liquidator must give prompt notice of disclaimer to every person whose rights are, to the knowledge of the liquidator, affected by the disclaimer.

4.10.2 Onerous property means (a) any unprofitable contract; and (b) any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform an onerous act. It does not include certain netting agreements[22] or any contract of the company that constitutes a transaction under a netting agreement. An example of onerous property would be a lease under which the company was the tenant and where the rent was greater than a market rent.

4.10.3 Where the counterparty has a proprietary as opposed to a personal interest in the property, there can be no disclaimer: for example, where the company is selling land, contracts have been exchanged and the buyer tenders the purchase price, the buyer is likely to be able to obtain specific performance of such a contract.

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

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[20] See generally discussion of directors duties in answer to Question 2
[21] Section 60 Property Law Act 1952
[22] See paragraph 4.2.4 for an explanation of this expression.

4.10.5 A person whose rights would be affected by the disclaimer of onerous property may require a liquidator to elect whether to disclaim that property – if the liquidator does not do so within a stated period after receiving notice of the requirement, the liquidator will be unable to disclaim the onerous property in the future.

4.11 Failure to register a charge[23]

4.11.1 Currently, New Zealand law operates a system of registration of charges created over certain property by New Zealand companies, and over property in New Zealand by overseas companies which have an established place of business in New Zealand. Generally speaking, failure to register within 30 days after creation renders the charge void against a liquidator or a creditor. Whilst it is the company's duty to register the charge, any party interested in the charge is able to and, indeed, is well advised to effect registration itself.

4.11.2 The types of charges which need to be registered are:

(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 created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale (most charges over chattels);

(d) a charge on land (wherever situated) or any interest in it;

(e) a charge on book debts of the company (where a negotiable instrument has been given to secure the payment of any book debts of a company, the deposit of the instrument for the purpose of securing an advance to the company is not treated as a charge on those book debts);

(f) a floating charge on the company's undertaking or property;

(g) a charge on calls made on shareholders but not paid;

(h) a charge on a ship, or any share in a ship;

(i) a charge on goodwill, on a patent or any licence under a patent, on a trade mark, or on a copyright or any licence under a copyright;

(i) a charge on any motor vehicle of the company;

(j) a charge on any management rights or licence under the Radio Communications Act 1989 in relation to which the company is the manager or right holder.

[23] Companies (Registration of Charges) Act 1993

However, if a charge is not registered under the Companies Registration of Charges regime but is registrable under another Act (whether or not it has been registered), it will not be void against a liquidator.[24]

4.11.3 It should be noted that the Personal Property Securities Act 1999 has recently been passed into law, but is not yet in force. This Act is intended to replace all existing legislation in relation to securities and registration of securities, over almost all types of personal property issued by any person (including companies). The Act is expected to come into force on 1 May 2002. When it does, unregistered security interests will not be void against a liquidator or any creditor of the company. If the security interest is not registered on the Personal Property Securities Register, the only consequence is that it will rank in priority after those interests which have been registered. An unregistered security interest will however remain enforceable against a liqiuidator 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 whom may action be brought against directors (and/or others identified in Question 3)?

5.1 Introduction

5.1.1 While not exclusively relevant to the "twilight" period, until liquidation the company is the appropriate applicant 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

[24] Section 103 Companies Act 1955 (as saved by the Companies (Registration of Charges) Act 1993); *Green* v *Meltzer* (1993) 6 NZCLC 68,383 (CA)). This applies particularly to charges over land, motor vehicles and some ships.

or fiduciary duties owed to the company. There are a few exceptions to this rule in respect of certain transactions for which action may be brought by creditors or others directly. These are detailed in the table below.

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.[25] The following acts are the main criminal offences under the Companies legislation relating to insolvency in respect of which the Registrar of Companies may bring an action against the directors and others involved. Those who may be liable in respect of the following offences in addition to the directors are listed in Question 3.

Offences

(a) Liability if proper accounting records not kept – section 194

(b) Carrying on business fraudulently – section 380

(c) Leaving New Zealand, concealing or removing company property or destroying, concealing or removing company records – section 273

(d) Failure to identify and deliver property to a liquidator – section 274

(e) Making false or misleading statements or omissions – section 377

(f) Fraudulently taking or applying company property for a non authorised use (or fraudulently concealing or destroying property) – section 378

(g) Destroying, mutilating, altering or falsifying any company document by making false entries – section 379

(h) Disqualification as a director – sections 382 - 386

5.3 Civil Proceedings

5.3.1 In relation to civil proceedings, after liquidation the ability to bring actions against directors and others lies primarily with the liquidator. However, in respect of certain actions which have caused loss to the company and its creditors, the law allows a wider range of persons to bring action to recover funds for the benefit of the company's creditors. Where an action for a contribution to the company's

[25] This duty is expected to be enacted in legislation amending the Companies Act 1993 to be passed in mid 2001.

assets is successful, even if the person bringing the action is not the liquidator, generally any recoveries made will be for the benefit of all creditors of the company and will be distributed amongst the creditors in accordance with the normal rules relating to priority.

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

Activity/transaction	**Person able to bring proceedings after liquidation**
Wrongdoing (s.301)	Liquidator, a creditor or a shareholder
Insolvent trading (ss.136 & 301)	Liquidator, a creditor or a shareholder
Reckless trading (ss.135 & 301)	Liquidator, a creditor or a shareholder
Failure to keep proper accounting records (s.300)	Liquidator only
Liability to repay distributions made to shareholders (ss. 56 & 301)	Liquidator, a creditor or a shareholder
Liability under Fair Trading Act 1986	The creditor or creditors to which the misrepresentation was made

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 debt incurred by the company after a date on which the Court considers the company was clearly insolvent and should have stopped trading. Where more than one director is involved each director may be held to be liable for different amounts, depending on the degree of involvement and culpability of the particular director and the duration of that director's involvement (s.301).
Distributions to Shareholders when, or as a result of which, the company is insolvent (s.56)	The distributions may in certain circumstances be recovered from the shareholder. To the extent that a distribution is not able to be recovered from the shareholder (either because the shareholder has no obligation to repay it or because the shareholder has insufficient assets or for any other reason), any director who failed to take reasonable steps to ensure the correct procedures for authorising distributions were followed, or who signed the required solvency certificate when there were no reasonable grounds for believing at that time that the company would satisfy the solvency test, will be liable to the company to repay the distribution.
Failure to keep proper accounting records (ss.194 & 300)	*Civil liability* A Court may order that the director is personally responsible for all or any part of the debts and other liabilities of the company. The Court has a wide discretion and will apply similar principles to those referred to under the insolvent and reckless trading offences. *Criminal liability* A director convicted of this offence is liable to a fine not exceeding $10,000.

Offence	Remedy Available
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.
Transactions having preferential effect (s.297)	If a transaction is set aside as against the liquidator, the Court may order one or more of the following: (a) that any property transferred as part of the impugned transaction be restored to the company; (b) that any property which represents the application of either the proceeds of sale of the property or money originally transferred be vested in the company; (c) the release or discharge of any security given by the company; (d) a person to pay such sums as represent the value of any benefits received by him from the company as a result of the transaction; (e) that security be provided for the discharge of any obligation imposed by or arising under the order; (f) the extent to which any person affected by the setting aside of a transaction or any order made as noted above may claim as a creditor in the liquidation (s.295). An order under these provisions cannot prejudice any interest in property acquired by a person from a person other than the company for value and without notice of the circumstances under which the property was acquired from the company (s.296).
Transactions for inadequate or excessive consideration with connected parties (s.298)	The liquidator may recover from the connected party the excessive value or the undervalue, as applicable.

Offence	Remedy Available
Securities and charges issued in favour of connected parties (s.299)	The Court can set aside the charge or security (in whole or in part). The Court may make such other orders as it thinks proper for the purpose of giving effect to an order setting aside the security. The Court cannot set aside a security which has subsequently been purchased by another person if the purchase was made in good faith and for valuable consideration, and if at the time of the purchase the purchaser was not a connected party.
Voidable charge (s.293)	The charge can be set aside in whole or in part. The setting aside of a charge or security can not prejudice the interest in property acquired by a person as a result of the exercise of a power of sale by the grantee of the charge and for valuable consideration and without knowledge of the circumstances relating to the giving of the charge, or acquired by an assignee of the charge for value and without notice (s.296).

QUESTION 7

7. Duty to co-operate

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

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

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

7.1.1 As soon as a company goes into liquidation, present and former directors of the company must give the liquidator details of the property of the company in their possession or under their control (s.274).

7.1.2 The liquidator can by notice require those persons to deliver that property to the liquidator or the liquidator's nominee, or to dispose of the property in the manner the liquidator directs (s.274).

7.1.3 The liquidator can require any person to deliver to the liquidator books, records or documents of the company in that person's possession or under that person's control. The liquidator can also require a former director, certain other persons, and any person 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)[26].

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

[26] A receiver of a company (appointed by the Court or by a chargeholder) is not required to deliver to a liquidator books, records or documents which the receiver requires, but the liquidator is entitled to have access to them. (s.262)

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

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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 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.[27]

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.[28] 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.[29]

8.1.5 Generally speaking proceedings against a director under the Fair Trading Act 1986 (refer Section 2.12 of this paper) must be commenced within 3 years after the date on which the conduct giving rise to the proceedings occurred.[30]

8.2 Appeals

8.2.1 Appeals are available from the decisions of the lower Courts.

QUESTION 9

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9. Foreign Corporations

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

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).

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[27] Section 4 Limitation Act, 1950
[28] Section 4 Limitation Act 1950
[29] Section 21(1) Limitation Act 1950
[30] Section 43 Fair Trading Act 1986

9.2 Liquidation of the New Zealand assets of an overseas company

9.2.1 Irrespective of whether the overseas company is registered as such in New Zealand, a creditor, director or shareholder of that company, or the company itself or the New Zealand Registrar of Companies, can apply to the High Court of New Zealand for the liquidation of that company's assets in New Zealand. The Court can order the liquidation of the New Zealand assets irrespective of whether the company has been placed in liquidation abroad, or has been dissolved or otherwise has ceased to exist as a company under the laws of any other country (s.342).

9.2.2 The liquidation of the New Zealand assets of an overseas company will be carried out in general terms in accordance with the standard liquidation regime for a New Zealand company. This means that the transactions entered into by an overseas company during the "twilight" period identified in Question 4 as being vulnerable to attack will, to the extent that those transactions took place in New Zealand or relate to the New Zealand assets of the overseas company, be vulnerable to attack under the provisions referred to in Question 4.

9.2.3 When an overseas company which has been placed in liquidation abroad has assets in New Zealand, it will usually be necessary for the foreign liquidator to seek the assistance of a New Zealand Court in taking control of the New Zealand assets. The authority of the liquidator appointed under the domestic law of the overseas company will generally be recognised in New Zealand (*Gavigan* v *Australasian Memory Pty Limited (In Liquidation)* (1997) 8 NZCLC 261,449).

9.2.4 Depending on the nature of the assets in question, the foreign liquidator may decide to proceed with formal liquidation in New Zealand of the New Zealand assets of the company. Generally speaking, a New Zealand Court will recognise the foreign liquidator's authority to make the liquidation application in the name of the company. In some cases, a liquidation of New Zealand assets may be unnecessary where there are no local creditors or where local creditors can be adequately safeguarded.

9.2.5 A liquidation of assets under section 342 would not preserve New Zealand assets for New Zealand creditors, as the normal pari passu rule relating to distribution to unsecured creditors should apply universally and not on a domestic basis – however it is thought that local creditors in New Zealand whose claims fall within the categories of claim which on a liquidation have priority over unsecured creditors, will retain their priority rights.

9.3 UNCITRAL Model Law on Cross-Border Insolvency

9.3.1 In February 1999 the New Zealand Law Commission recommended that New Zealand adopt the United Nations Commission on International Trade Law's Model Law on Cross Border Insolvency, with minor amendments.[31]

9.3.2 The Model Law seeks to provide uniformity of approach to the initiation of cross-border insolvency proceedings while allowing for flexibility of approach, on a case-by-case basis, to the finding of solutions. The Law Commission's recommendation has received considerable support from all those involved in company administration and insolvency law issues, and legislation is likely to be enacted to give effect to that recommendation, in 2002 - 2003.

QUESTION 10

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10. Insurance

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

10.1 Directors' and employees' liability insurance is available in New Zealand. Policies offer cover for "wrongful acts", typically breach of duty while acting i as a director or employee. The policies are often drafted broadly enough to cover directors and employees sued for failing to exercise diligent control over management and thus failing to safeguard against losses caused by reckless decisions and by embezzlement. Cover is also available to the company itself if it pays out under an indemnity it grants to the director or employee.

10.2 In general, these policies do not specifically deny indemnity to companies or directors for liabilities arising from insolvent trading. However, on the ground of public policy, the policies do not allow for insurance against liabilities arising from directors' or employees' deliberate fraudulent acts or omissions, wilful breaches of duty or legislation and deliberate criminal acts. Arguably, in certain situations insolvent trading that involves the directors in personal liability could come within these general exclusions, so that directors are not insured.

10.3 A company may effect insurance cover for, or pay the premium for policies taken out to cover, directors and employees in respect of:

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[31] New Law Commission Report No. 52 *Cross Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross Border Insolvency (1999).*

(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.

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"[32]).

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*[33] 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.[34] Similar principles apply in New Zealand.

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

[32] 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.

[33] (1966) 115 CLR 666.

[34] 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.

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 procedure begins. In New Zealand, the main periods are two years for transactions having preferential effect, one year for transactions at an undervalue, and one year for voidable charges.

11.2.2 Generally speaking, a transaction which an unconnected third party enters into with a company during the twilight period in the ordinary course of business and for "market" value at the time will not be struck down where the company is subsequently the subject of the formal insolvency process (liquidation). For instance, if security for debt is given at the time of incurring the debt, the security cannot be challenged later, but if the security is given for an earlier debt, this can be challenged by the liquidator.

11.2.3 Payments to unconnected third parties in the ordinary course of business, where no pressure has been applied by the third party and where the third party is unaware of the insolvency of the company or any breach of duty of the directors in allowing the company to make payment, are also not vulnerable to attack. In certain situations payments outside the ordinary course of business may not be affected by a later liquidation either.

11.2.4 Full details of the types of transaction entered into by a company before the commencement of formal insolvency proceedings which are vulnerable to attack, and the defences available to the other party or parties to the transaction, are set out in Question 4.

APPENDIX
Summary of NEW ZEALAND insolvency procedures and commercial issues

Introduction – possible law reforms

The New Zealand Government is in the process of conducting a review of a number of aspects of insolvency law. It has released discussion papers on reform of the voidable transactions regime in a liquidation, priority debts in the distribution of assets of insolvent corporates and individuals, compromises with creditors (referred to below) and business rehabilitation regimes, and the statutory management regime (referred to below).

Legislation giving effect to reforms in these areas is likely to be introduced into Parliament in the second half of 2002. That legislation may result in changes to the law relating to a number of topics covered by this paper, particularly director liability and the law relating to transactions vulnerable to attack.

1. Summary of insolvency regime in New Zealand

1.1 The insolvency regime in New Zealand is contained mainly in the following legislation:

(a) *Insolvency Act 1967* - insolvency of natural persons

(b) *Companies Act 1993* - insolvency of corporations

(c) *Receiverships Act 1993* – receivers appointed over the assets of natural persons or corporations

(d) *Corporations (Investigation and Management) Act 1989* – can be used to regulate the affairs of corporations at risk, and associated persons (including natural persons) of those corporations.

1.2 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.

1.3 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.

1.4 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.

2. Summary of insolvency procedures for corporations

Compromises with Creditors

2.1 The board of directors of a company, a receiver of all or most of the assets and undertaking of the company (see paragraph 2.6 below) or, with the leave of the Court, any creditor or shareholder of the company, if they believe that the company is insolvent (unable to pay its debts) or is likely to become insolvent, can initiate a compromise proposal with creditors of the company.

2.2 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).

2.3 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.

2.4 The Courts are not involved except:

- at the request of the proponent or the company, to impose a short moratorium period while the proposed compromise is being considered by creditors (proceedings in relation to debts are prohibited, although this does not affect secured creditors rights to enforce their security); or

- to deal with disputes or irregularities on the application of a disaffected creditor.

Liquidation of the company

2.5 This is also known as winding up. This can be a voluntary process instigated by the shareholders or an involuntary process by Court order (almost always initiated by creditors). A liquidator is appointed whose role is to realise the assets of the company and distribute proceeds to creditors in accordance with statutory priorities. A liquidator has the right to avoid some transactions entered into before winding up.

Receivership

2.6 Secured creditors stand outside winding up, and often stand outside formal creditors compromises. The right of secured creditors to realise their security is not affected by a creditors compromise (unless they agree) or, generally speaking, on liquidation of a debtor company. A secured creditor who holds a charge over all the assets of an insolvent company can generally appoint a

receiver over those assets. With certain statutory exceptions, the secured creditor has first rights over the assets of that company until its debt is paid in full.

The Court also has power, separately from a secured creditor, to appoint a receiver where the Court considers it appropriate to do so. The legislation dealing with receiverships (including Court appointed receivers) is the Receiverships Act 1993.

Statutory Management

2.7 Statutory management is a legal regime that can apply to any corporation which is operating fraudulently or recklessly, or to which it is desirable that the Act should apply:

- for the purpose of preserving the interests of the corporations' members or creditors; or
- for the purpose of protecting any beneficiary under any trust administered by the corporation; or
- for any other reason in the public interest,

if those members, creditors, or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1993 or in any other lawful way.

2.8 Statutory Managers are appointed by the Government in accordance with a recommendation of the New Zealand Securities Commission which must be satisfied that certain statutory criteria are met before it makes a recommendation.

2.9 Historically statutory management has been applied to companies or groups of companies which have problems of such an extraordinary nature that the ordinary insolvency regime under the Companies Act cannot deal adequately with them (for example, because of the size, complexity, or importance of the corporations' activities).

2.10 Statutory management cuts across the rights of the corporations' creditors far more extensively than do ordinary insolvency regimes. The liquidation of the company is only one of the possible options for a statutory manager. The aim of statutory management is to freeze the position of the corporation so as to preserve the interests of members, creditors and the public, and to resolve the difficulties of the corporation. Extensive moratorium provisions apply which preclude creditors, including secured creditors, from exercising rights and powers against the corporation. The regime contains provisions allowing the statutory manager to suspend obligations and terminate certain contracts.

2.11 The statutory management regime is rarely used – it has been applied to only 6 groups of corporations since 1989.

3. Summary of commercial issues

3.1 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.

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

3.3 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.

3.4 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.

3.5 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.

3.6 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.

3.7 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.

3.8 The Registrar of Companies can also take steps to disqualify directors, although this action usually takes place well after the liquidation has concluded.

3.9 Actions by liquidators to set aside voidable transactions are commonplace (in New Zealand there is no requirement to prove an intention to prefer a creditor, but the transaction must have been outside “the ordinary course of business” – a concept about which there is uncertainty and much judicial comment). These actions do not, however, universally result in a net return to creditors.

3.10 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.

USA

Introduction

Background discussion of applicable law.

A multiplicity of jurisdictions.

Any discussion of the potential liability of officers and directors of an insolvent business entity in the United States must first recognize the multiplicity of jurisdictions whose law may apply to address the various issues.

Generally, the internal affairs of a business entity are governed by the law of its jurisdiction of formation. This proposition is commonly known as the internal affairs doctrine. Accordingly, Delaware law will govern issues pertaining to the internal affairs of a corporation formed under Delaware law and New York law will govern the affairs of a corporation formed under New York law and so on. The internal affairs of a corporation or limited liability company include issues of governance, capitalization, dividends and the fiduciary duties of its managers.

Other important issues that are discussed in this paper may not fall within the internal affairs doctrine, because the issue is not limited to the internal workings of the entity. For example, what law governs a claim that the transfer of corporate property to its corporate parent for less than fair value should be avoided as a fraudulent transfer where the corporation is formed in Delaware, its main office is in New York, the transferred property is located in California and the complaining creditor brings suit in Texas? The point of the question is that in the United States, choice of applicable law can be a complicated matter and there are fifty-two separate jurisdictions (each of the states, Federal law and the District of Columbia).

Generally, this paper will focus on the corporate law of Delaware, because Delaware remains a popular jurisdiction for incorporation and on Federal law. Federal law is of importance because many of the issues raised in this paper are litigated and resolved in the United States Bankruptcy Court, not in the state courts. This paper will highlight noteworthy State law decisions other than Delaware when appropriate.

Practice Consideration: Counsel must always be aware of the state of incorporation or formation of the relevant business entity. The law of the state of incorporation (or formation in the case of a limited liability company or limited partnership) will govern many important questions relating to the potential liability of its officers and directors.

Statutory references.

In 1978 the U.S. Congress passed the Bankruptcy Reform Act of 1978, replacing the Bankruptcy Act of 1898. The Reform Act is commonly referred to as the **United States Bankruptcy Code** and is codified at Title 11, 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 38 States and the District of Columbia. 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 except Louisiana has enacted the **Uniform Commercial Code ("UCC")**. The UCC is cited in the text in reference to the rights of sellers of goods to an insolvent buyer. 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 bylaws, which are the procedural rules for the governance of the corporation. As will be seen below, a corporation's bylaws 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

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

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 39 jurisdictions, insolvency is defined using the balance sheet test, but is presumed if the equity standard is satisfied. Under the United States Bankruptcy Code, an involuntary petition for relief filed against a debtor shall be granted if the entity is not paying its debts generally as they come due.

The Delaware Chancery Court in two recent cases, both involving actions brought by shareholders against directors for breach of fiduciary duties, has defined how to determine insolvency. In *Francotyp-Postalia Ag & Co. v. On Target Tech., Inc.,* No. 16330, 1998 Del Ch. WL 928382 (Del. Ch. Ct. Dec. 24, 1998), the court rejected the balance sheet approach and stated that a corporation is insolvent "when a corporation is unable to meet its debts as they fall due in the usual course of business. *Id.* at *5. The Court rejected the balance sheet approach because it "ignores the realities of the business world in which corporations incur significant debt in order to seize business opportunities. [This approach] could lead to a flood of litigation arising from alleged insolvencies and to premature appointments of custodians and potential corporate liquidations." *Id.* In *Odyssey*

Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386 (Del. Ch. 1999), the court adopted the equity approach in defining insolvency without a discussion of any alternatives. These cases indicate that Delaware has determined that a corporation becomes insolvent when it is "unable to pay its debts as they fall due in the usual course of business." *Id.* at 417.

QUESTION 2

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2. Actions potentially giving rise to liability for officers and directors.

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, 306, 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); *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, 29 N.E. 725, 727 (1895) ("It is the duty of 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.").

Practice Consideration: Courts in the United States have recognized that the fiduciary obligations of directors "switch" from a duty owed to shareholders to a duty owed to creditors when the entity is insolvent or in the shadow of insolvency. This means that the first allegiance of directors of an insolvent entity must be to creditors and that creditors may bring an action against the directors for breach of fiduciary duty.

iii. The Business Judgment Rule.

A majority of jurisdictions, including Delaware, provide corporate directors with a safeharbor 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 (Bkrptcy. 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, Seventh Edition (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 for the property of the corporate creditor-beneficiaries." *Id.* Since the assets could have been sold for more money, the directors could be held liable for the difference, regardless of their good faith or motive in the transaction. This

standard would apply even if the corporation was solvent, if insolvency was imminent. *See id.*[1] Strict application of the trust fund doctrine fully protects creditors of an insolvent corporation but, the doctrine may make people reluctant to become directors for fear of personal liability. As a result, only a minority of jurisdictions have adopted strict adherence to the trust fund doctrine.

v. The "At Risk" Transaction. In *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 1991 WL 277613 (Del.Ch. December 30, 1991) the directors were sued by a shareholder holding 98% of the company's stock for breach of fiduciary duty *to the shareholder*. The corporation, MGM post leveraged buyout, was operating "in the vicinity of insolvency". The shareholder complained that the directors had failed to approve a sale of assets which the shareholder sought because the proceeds of the sale would have paid down bank debt and returned control of the company from the bank to the shareholder. The directors refused to authorize the sale because they suspected that the sale price was too low and that the shareholder was principally concerned with paying down bank debt to regain control and not maximizing the value of the company's assets. In ruling that the directors had not breached their duty to the shareholder, the Chancellor stated:

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. [T]he MGM board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity. *Id.* at fn. 55.

The Chancery Court noted that the "possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior, 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:

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[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.

> [I]f we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than [the value of the claim divided by the probability of success] and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act. *[Id.]*

> The court concluded that the directors had not breached duties owed to the 98% shareholder in refusing to authorize a sale of assets at fire sale prices. The director's duty, in the shadow of insolvency, is owed to the entity, not merely to a single constituency.

> In *In re Ben Franklin Retail Stores, Inc.,* No. 97C7934, 97C6043, 2000 U.S. Dist. WL 28266 (N.D. Ill. Jan. 12, 2000), the officers and directors of the insolvent corporation were accused of overvaluing their receivables to induce creditors to lend the corporation money. *See id.* at *2. The creditors were harmed because the corporation sank deeper into insolvency as its liabilities grew. *See id.* Applying Delaware law, the Illinois District Court held that directors do not owe a duty to liquidate and pay their creditors when the corporation is near insolvency, provided the directors have a good faith belief that an alternative exists to maximize the corporation's long term wealth. *See id.* at *4. The court cited *Credit Lyonnais* for the principle that when a corporation is operating in the vicinity of insolvency, directors owe a duty to the corporate enterprise, not just the creditors or the shareholders. *See id.* This case indicates that directors cannot be held liable by creditors when a corporation is operating in the vicinity of insolvency absent self-dealing, bad faith or fraud. The court rejected a strict application of the trust fund doctrine and upheld the business judgment rule for directors in the context of insolvency.

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. sec. 363. Court approval, following notice to creditors and hearing, ought to insulate corporate directors from liability with respect to the proposed transaction, provided that the transaction and its consequences have been accurately disclosed in the court filings.

Practice Consideration: Another reason for the popularity of reorganization proceedings under chapter 11 of the Bankruptcy Code is the reduction or the removal of the risk that the continued accrual of unpaid trade debt will result in liability to the directors of the entity. Upon filing, the debtor is prohibited in most circumstances for paying any prefiling unsecured debt other than by means of a Plan of Reorganization. The freeze on paying existing trade debt inevitably creates a cash flow benefit that should enable the debtor to meet its current obligations, at least for a time. Continued failure to pay trade debt following a chapter 11 filing, however, is not permitted and can lead to various consequences, including conversion to chapter 7.

vi. Another Example: *In re Healthco Intern., Inc*., 208 B.R. 288 (Bkrtcy, D. Mass. 1997). Healthco involved a business failure following a leveraged buyout. Applying Delaware law, the Bankruptcy Court ruled as follows:

- The bankruptcy trustee has standing to bring a breach of fiduciary duty claim against the directors of the failed company, because the duty is owed to the debtor and breach of that duty is a claim of the debtor. *Id* at 300.[2]

- When a transaction renders a corporation insolvent or brings it to the brink of insolvency, "the rights of creditors become paramount". *Id.*

- 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

[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 control the administration of the bankruptcy estate during the proceeding.

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 defense based on the business judgment rule is that the director have adequately informed herself with respect to the matter under consideration. Two Healthco directors who may not have had a material interest in the outcome of the LBO, nonetheless cannot avail themselves of the business 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 39 jurisdictions, with some local variation. UFTA governs those circumstances under which the transfer of property or the incurrence of an obligation by an insolvent entity may be avoided by creditors of the entity. Generally, the officers and directors of an insolvent entity risk liability under UFTA only if they are the transferee of the property of the insolvent entity. However, the directors of an insolvent entity risk liability for breach of their fiduciary duties to creditors (or to the company) if they vote for or permit the insolvent entity to engage in or undertake a fraudulent transfer.

Transfers Avoidable by Existing Creditors. Under UFTA, a transfer of property or the incurrence of an obligation is avoidable by existing creditors of the entity if the transfer was made or the obligation incurred for less than reasonably equivalent value and the debtor was insolvent at the time of the transfer or incurrence of the obligation or was rendered insolvent thereby.

Transfers Avoidable by Existing and Future Creditors. Under UFTA, a transfer of property or the incurrence of an obligation is avoidable by existing and future creditors of the entity if:

i. The transfer was made or the obligation incurred with actual intent to hinder, delay or defraud creditors; or

ii. The transfer was made without receiving reasonably equivalent value and the debtor:

   a. was engaged or was about to engage in a business or a transaction for which the remaining assets of the entity were unreasonably small in relation to the business activity to be undertaken; or

   b. intended to incur or reasonably should have believed that it would incur debts beyond its ability to pay as those debts came due.

Practice Consideration: A majority of the breach of fiduciary duty claims against directors of an insolvent entity relate to the director's authorization

of a transaction that is challenged as a fraudulent transfer. These challenged transfers generally take one of two forms:

i. The transfer of property from the insolvent entity to a corporate parent, either in the form of the outright conveyance of tangible or intangible property or in the form of a dividend; and

ii. The incurrence of a debt by the insolvent entity where the entity receives little or no value on account of the obligation. The classic examples include:

   a. The guaranty of the obligations of the parent or an affiliate; and

   b. The incurrence of debt in the context of a "leveraged buy out". In a leveraged buyout, the entity incurs debt and encumbers its assets to enable the acquirer to buy the stock of the selling shareholders.

Directors asked to approve any of the foregoing transactions should be aware that they risk liability to existing and future unpaid creditors of the insolvent entity.

c) Director liability for unlawful dividends and redemptions

Each state's corporation's law specifies the circumstances under which the corporation can redeem its outstanding shares or issue and pay dividends. Likewise, each state's corporations law set forth the penalties that may be imposed on directors that authorize a dividend or a redemption in violation of the applicable standards.

Under Delaware law, directors have liability for the willful or negligent violation of the applicable provisions of Delaware corporation's law governing the redemption of stock or the issuance of dividends. In either case, the directors are each jointly and severally liable to the corporation and its creditors for the full amount paid out in dividends or on account of the redemption.

Delaware law provides that a corporation may not redeem outstanding shares when its capital is impaired or would be impaired by the redemption. This means that the corporation may only use capital surplus to effect a redemption. Capital surplus may generally be thought of as the amount by which the total assets of the company exceed its total liabilities. If a promissory note or other debt instrument is given as payment for a redemption, the legality of the redemption is determined at the time the debt instrument is delivered, not at the time it is payable. Delaware law provides generally that dividends also may only be paid from surplus or from net profits of the current or preceding year.

Directors of Delaware corporations should value assets on a current basis to determine if surplus exists to pay a dividend or redeem stock. Directors acting in good faith and subject to a standard of reasonableness are entitled to rely upon reports, appraisals and other information provided to the corporation in determining the value of the corporation's assets.

Practice Consideration: A dividend by an insolvent or struggling business entity is an obvious suspect and directors who vote for such a dividend

may incur personal liability in the amount of the dividend. Counsel must review the relevant State corporation law to study the standards that must be met before the entity may legally make a distribution to its owners. Counsel should also look for any safe harbors 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 favor of a dividend, they are found liable as directors for assenting to an unlawful distribution where they actually received the proceeds of the distribution).

d) Liability for "trust fund" taxes

Under 26 U.S.C.A. § 6672(a), any person required to collect, account for, and pay over any federal tax who willfully fails to do so, or willfully 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 1309, 1312 (1st Cir. 1974); Gardoury v. U.S., 187 B.R. 816, 823 (D.R.I. 1995); In re Bourque, 153 B.R. 87, 92 (Bankr.D.Mass. 1993). Each person liable under § 6672 enjoys a right of contribution against other liable persons, but an action to recover the excess of one proportion may not be joined or consolidated with federal § 6672 actions or counterclaims. See 26 U.S.C.A. § 6672(d).

For purposes of § 6672, a "person" is defined statutorily to include not only the taxpaying entity itself, but also "an officer or employee of a corporation, or member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." 26 U.S.C.A. 6671(b). Statutorily exempt from § 6672(a) are unpaid, volunteer trustees or directors of tax exempt organizations who serve solely in an honorary capacity, do not participate in the organization's day-to-day or financial operations, and lack actual knowledge of the failure to account for the taxes, *unless* this exemption would result in no person being liable for the penalty. See 26 U.S.C.A. § 6672(e).

However, the definition of "responsible person" for purposes of § 6672 is limited neither to the statutory enumeration nor to persons performing the "mechanical functions of collection and payment." Harrington, 504 F.2d at 1312 (citations omitted). Rather, it extends broadly to persons with authority and responsibility to avoid the default. See id. The First Circuit has indicated that factual "[i]ndicia of responsibility include the holding of corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees." Thompsen 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 defense 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); Sokaogan Chippewa Community Tribal Council v. U.S., 959 F.Supp. 1032 (E.D.Wis. 1997) (tribe owned business and council oversaw hiring and certain financial transactions).

The federal "trust fund taxes" to which § 6672 applies are all funds collected by the taxpayer from third parties and deemed a special fund in trust for the United States pursuant to 26 U.S.C.A. § 7501. See Harrington, 504 F.2d at 1311. These most prominently include withheld employee social security taxes (see Harrington, 504 F.2d at 1311 n.2.) and withheld employee income taxes (see Thomsen, 887 F.2d at 14), but also include federal excise taxes (see 26 U.S.C.A. §§ 4001-4682) and collections on gambling winnings (see 26 U.S.C.A. § 3402(g)), interest and dividend payments subject to backup withholding (see 26 U.S.C.A. § 3402(q)), distribution from retirement plans (see 26 U.S.C.A. § 3405(e)), payments of interest and dividends to nonresident aliens and foreign corporations (see 26 U.S.C.A. §§ 1441-42), and disposition of United States real property interest by foreign persons (see 26 U.S.C.A. § 1445).

IRS policy permits the taxpayer to designate its tax payments first toward trust fund taxes, in order to eliminate personal liability, where such payments are "voluntary." See U.S. v. Energy Resources Co., Inc. 871 F.2d 223 (1st Cir. 1989) affirmed 110 S. Ct. 2139 (1990); In re Kaplan, 104 F.3d 589, 596 n.16 (3rd Cir. 1997). The IRS traditionally considers payment involuntary where it results from a distraint, levy, or legal proceeding in which the U.S. seeks to collect delinquent taxes. See Energy Resources, 871 F.2d at 228 (citations omitted). Where the taxpayer fails specifically to designate allocation of the voluntary payment, the IRS may allocate it. See Sotir v. U.S., 978 F.2d 29 (1st Cir. 1992). However, where there would have been no recovery of tax funds at all if not for the debtor corporation's efforts to collect funds owed it by a third party, the court may grant equitable recognition of the debtor's efforts by directing the IRS to allocate the collected funds toward trust fund obligations. See New Terminal Stevedoring, Inc. v. M/V Belnor, 728 F.Supp. 62 (D.Mass. 1989).

Regardless of whether the payments are voluntary or involuntary, the Supreme Court has held that a bankruptcy court has the authority in a Chapter 11 reorganization to order the IRS to allocate the payments first toward trust fund taxes, if the court deems such designation "necessary for the reorganization's success." Energy Resources, 495 U.S. at 549. 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 (BkrtcyN.D.Fla. 1996) (argument that debtor's

allocation would increase incentive of responsible person to participate in reorganization was insufficient evidence to warrant finding of necessity); U.S. v. R.L. Himes & Assoc., Inc., 152 B.R. 198, 200-01 (S.D. Ohio 1993) (upholding bankruptcy court finding of necessity where debtor's principal testified that corporate officers' incentive to pursue successful reorganization would be greatly diminished if they remained liable for trust fund taxes); In re. M.C. Tooling Consultants, Inc., 165 B.R. 590 (BkrtcyD.S.C.1993) (finding necessity where debtor's principal testified that he had been unable to concentrate on business operations due to IRS harassment over debtor's trust fund tax liability). Courts have split over whether a bankruptcy court may also direct allocation in a Chapter 11 liquidation plan. See e.g., In re Deer Park, Inc., 10 F.3d 1478 (9th Cir, 1993) (yes, where necessary to the success of the liquidation); In re Kare Kemical, Inc., 935 F.2d 243 (11th Cir. 1991) (no, since there is no "reorganization" for which the allocation is necessary).

Practice Consideration: Responsible person liability for unpaid trust fund taxes should be avoided at all costs. The liability cannot be discharged even in a personal bankruptcy proceeding. The lesson is simple (but still routinely ignored): Do not borrow from the United States Internal Revenue Service!

e) Insider preferences.

The law of preferences governs those circumstances where a creditor may have to repay money to a debtor or its estate or relinquish a lien on property of the debtor for the purpose of achieving a more equitable distribution of the debtor's property. There are two sources of preference law: the Bankruptcy Code and UFTA.

Insider Preferences Under the Bankruptcy Code. Under the Bankruptcy Code, a transfer of the debtor's property on account of an antecedent debt made to an insider while insolvent and within one year of an order for relief under the Bankruptcy Code is recoverable by the trustee of the debtor for the benefit of the debtor's estate. See 11 U.S.C. sec. 547. The definition of insider is found at 11 U.S.C. sec. 101(31) and includes an officer, director, person in control of the debtor, relative of any of the foregoing and any equity holder holding 20% or more of the debtor's voting securities. 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 undersecured debt within the relevant preference period. The preference period for non-insider transferees is ninety (90) days.

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. This means that a creditor of the debtor entity can recover the amount of the preference from the insider. The statute of limitations for such a claim is six years.

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 defense to Section 11 liability is due diligence. To establish that defense, 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 1944.

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 favor of the purchaser or the seller of a security under Section 10(b) of the Exchange Act.

Merely negligent conduct by and officer or director will not give rise to liability under Section 10(b) of the Exchange Act. The United States Supreme Court has ruled that a plaintiff must prove by a preponderance of the evidence that the

defendant acted with "scienter", a mental state that encompasses knowing or intentional deception, manipulation or fraud.

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 or the Superfund. CERCLA provides responsibility and remedies for the disposal and cleanup of uncontrolled hazardous waste sites. The 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.

Owners, officers or directors risk personal liability under CERCLA or RCRA when they personally engage in the conduct of the business entity that violates the relevant statute. For example, if the officer directed the offending activities, that officer risks personal liability. Some courts have imposed personal liability on officers where the officers had authority over the disposal activities of the company, but did not exercise that authority and did not participate in the illegal conduct. In that instance, the officer has liability because the officer could have prevented the illegal conduct.

Practice Consideration: Any officer, director or owner that actively participates in conduct by a business entity that violates CERCLA, RCRA and other federal and state environmental laws risks personal civil and criminal liability. Enforcement authorities in the United States have not hesitated to seek to impose personal liability due to involvement in the violation of remedial environmental laws. The United States Department of Justice has a separate unit devoted exclusively to prosecuting criminal violations of the federal environmental laws. The risk of personal liability is undoubtedly greater where the business entity has failed, because the entity cannot practically ameliorate the harm or pay a fine.

Traditional arguments for disregarding the corporate form (veil piercing) have also been used to impose liability on individual officers, directors and owners of business entities.

h) Liability for misappropriation of corporate opportunities.

Misappropriation of corporate opportunities is a special form of self-dealing that can result in individual liability to officers and directors. In *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966), the supreme court of Delaware stated the standards for when an opportunity must be presented to the corporation:

When there is presented to a corporate officer a business opportunity which the corporation is financially able to undertake, and which, by its nature, falls into the line of the corporation's business and is of practical advantage to it, or is an opportunity in which the corporation has an actual or expectant interest, the officer is prohibited from permitting his self-interest to be brought into conflict with the corporation's interest and may not take the opportunity for himself.

Practice Consideration: Business entities in financial distress are seldom in a position to take advantage of a new business opportunity, but that will not prevent a representative of the failed company's creditors from seeking damages from an officer or director that misappropriates a corporate opportunity. An insider of a struggling business entity risks liability (or at least the cost of defending a suit) if his basis for appropriating a corporate opportunity is the financial ill health of the corporation that he serves.

QUESTION 3

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3. Other Persons Involved with the Debtor's Affairs that may have Liability In Respect to their Actions During the Twilight Period.

a) Lender liability and equitable subordination.

Lender liability is the generic term used to describe those circumstances under which a lender to the debtor may incur liability on account of its conduct. Lender liability claims run the gamut, from breach of contract to slander. In the context of an insolvent business entity, a lender's risk is more specific: Equitable subordination due to misconduct. The Bankruptcy Court has the power under Code sec. 510 (c) to readjust the priorities of claims and therefore subordinate one claim to another due to misconduct by the creditor.

i. Equitable Subordination of Non-Insider Claims. Lender's claims against an insolvent entity are not frequently subordinated. Those instances leading to subordination usually involve misconduct by the lender to the detriment of the debtor's unsecured creditors. 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 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. nonobservance 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. nonfunctioning 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 (2nd Cir. 1991). The Maine Supreme Judicial Court recently ruled that the corporate veil may be pierced where (i) the shareholder misused the corporate form and (ii) "an unjust or inequitable result would occur if the court recognized the separate corporate existence." *Johnson v. Exclusive Properties Unlimited*, 720 A.2d 568 (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

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QUESTION 4

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4. Counterparties dealing with the debtor during the twilight period.

a) Trade Creditors.

Trade creditors are well advised to do business on a cash only basis if they have reason to believe that they are selling to an insolvent entity. A C.O.D. transaction is never a preference under the Bankruptcy Code. UCC section 2-702 expressly authorizes a seller of goods to refuse delivery to an insolvent buyer other than upon cash payment.

b) Rights of reclamation.

Goods sold to an insolvent entity may be reclaimed upon demand made within ten days after delivery of the goods pursuant to UCC section 2-702. A seller's right to reclamation is subject to the rights of a buyer in the ordinary course or other good faith purchaser. Most courts have ruled that the seller's right to reclamation is inferior to the rights of a lender with a "floating" lien on the Debtor's inventory.

Practice Consideration: A seller should always make demand for reclamation in writing. Even following a filing under the Bankruptcy Code by the buyer, a timely claim for reclamation gives the seller valuable rights in the buyer's bankruptcy proceeding.

c) A purchaser of assets other than in the ordinary course.

A purchaser of substantially all assets of an insolvent or failing enterprise must have several concerns:

i. Can the Seller convey clear title to the assets?

ii. Will the buyer have liability for any of the Seller's obligations, such as trade debt, tax liabilities, employment-related liabilities or warranty or tort liabilities?

iii. If the buyer strikes too good a deal, might the transaction be avoided as a fraudulent conveyance?

Practice Consideration: Buyer's of the assets of a failing enterprise often require that the Seller file under chapter 11 of the Bankruptcy Code so that the transaction can be consummated in the Bankruptcy Court. Although this procedure results in higher transactional costs, the buyer is far safer with an order of the Bankruptcy Court conveying the assets of the seller to the buyer free and clear of liens, claims and encumbrances.

QUESTION 5

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5. Enforcement

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

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6. Remedies; orders available to 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 are jointly and severally liable 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 bylaws 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 varies among jurisdictions.

The authority of a Delaware corporation to indemnify its officers and directors is found at Del. Code Ann. tit. 8, sec. 145. Section 145 authorizes indemnification against expenses, including attorney's fees, judgments, fines and amounts paid in settlement actually and reasonably incurred "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful.

Practice Consideration: Mandatory indemnification should probably be limited to directors and officers of the corporation, and not extended to employees and other agents. The 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 $10,775 may commence an involuntary petition against the debtor. If the debtor has twelve or more creditors, three or more unsecured creditors whose claims aggregate $10,775 may commence the involuntary proceeding. Claims that are in bona fide dispute are not eligible as petitioning claims. 11 U.S.C. sec. 303.

Unsecured creditors are most likely to commence an involuntary petition in those circumstances where they suspect that the debtor has been engaged in fraudulent conveyances or other misconduct.

The Bankruptcy Court will enter an order for relief under the Bankruptcy Code if it finds that the debtor is not generally paying its debts when they come due, unless such debts are in bona fide dispute. 11 U.S.C. sec. 303(h).

An involuntary petition may be filed against a debtor under chapter 7 or chapter 11 of the Bankruptcy Code. Chapter 7 is a straight liquidation where a trustee is appointed to assemble and liquidate the debtor's property. Chapter 11 is discussed in the following section of the materials.

A "foreign representative" may commence an action ancillary to a "foreign proceeding" for the purpose of administering assets located in the United States pursuant to Bankruptcy Code section 304.

Practice Consideration. A foreign corporation may be a debtor under chapter 7 or chapter 11 of the Bankruptcy Code if it has a place of business in the United States or if it has property in the United States.

Practice Consideration. A debtor has the absolute right to convert an involuntary case under Chapter 7 of the Bankruptcy Code to a case under Chapter 11 of the Bankruptcy Code.

QUESTION 7

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7. Duty to cooperate.

a.) In the Bankruptcy Court.

Schedules. Bankruptcy Code section 521(1) requires that the debtor file a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures and a statement of the debtor's financial affairs. Official forms are prescribed for each of these filings. 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 to complete the schedules. Fed. R. Bankr. P. 9001(5).

Cooperation. Bankruptcy Code section 521(3) requires that the debtor cooperate with any trustee to enable the trustee to discharge his duties under the Bankruptcy Code. In a liquidation case, that cooperation will ordinarily relate to informing the trustee of and assisting in locating property of the estate in the possession of third parties. Cooperation may also involve assisting the trustee in evaluating claims against the debtor or claims in favor of the debtor. If the debtor is an entity, the duty to cooperate may be compelled from a corporate officer. Matter of Ron San Realty, Inc., 457 F. Supp. 994 (S.D.N.Y. 1978).

Turnover. Bankruptcy Code section 521(4) requires that the debtor surrender to the trustee all property of the estate and any recorded information, including books, documents, records, and papers related to property of the estate.

Practice Consideration. The knowing failure to disclose property of the debtor to the trustee or the knowing withholding of recorded information may constitute a crime under Title 18 of the United States Code.

Appearance. Bankruptcy Code section 341 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).

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

Please see question 6

QUESTION 9

9. Foreign Corporations

A foreign corporation or other foreign business entity may be a debtor under the United States Bankruptcy Code if it has a place of business in the United States or if it has assets in the United States. Accordingly, a foreign corporation doing business in the United States may seek relief under chapter seven (liquidation) or chapter 11 (reorganization) of the Code and creditors of the entity may file an involuntary petition under the Code against the foreign entity. 11 U.S.C. sec. 109. Bankruptcy Courts in the United States have exercised jurisdiction over foreign debtors when the nexus with the United States was as little as a bank account or a clearing account.

Entities that are the subject of a foreign insolvency proceeding or their representative may also seek relief under the Code to administer assets in the United States. 11 U.S.C. sec. 304. Such relief may include issuance of an injunction to prevent creditors in the United States from executing on assets of the debtor located in the United States. In determining whether to exercise jurisdiction over the assets of a foreign debtor, the Bankruptcy Court considers the interests of creditors in a timely distribution of assets of the debtor, the convenience or difficulty in establishing claims against the debtor in the foreign proceeding, the prevention of preferences and fraudulent conveyances and the distribution priorities applicable under the foreign insolvency scheme.

A representative of a foreign entity undergoing insolvency proceedings in a foreign jurisdiction may also seek dismissal of a bankruptcy proceeding under the Code on the basis that the factors listed above (the interests of creditors in a timely distribution of assets of the debtor, the convenience or difficulty in establishing claims against the debtor in the foreign proceeding, the prevention of preferences and fraudulent conveyances and the distribution priorities applicable under the foreign insolvency scheme) weigh in favor of the single insolvency proceeding pending in the foreign jurisdiction. 11 U.S.C. sec. 305.

If the Bankruptcy Court asserts jurisdiction over a foreign debtor or its assets, the Court may permit the application of the Bankruptcy laws respecting the recovery of preferences, fraudulent conveyances and the turnover of the debtor's property. Application of these laws in the United States proceeding relating to a foreign

debtor will likely depend on the size and sophistication of the United States creditor body, the status of a foreign insolvency proceeding, if any, and the substantive law that will apply in the foreign proceeding. If as a practical matter the ability of United Creditors to be paid depends upon the application of U.S. laws respecting preferences, fraudulent conveyances and/or turnover of estate property, the Bankruptcy Court is likely to allow application of these laws. In that event, officers and directors of foreign entities will be subject to the same substantive law that applies to officers and directors of domestic business entities. For this reason, officers and directors of foreign business entities should expect that unpaid creditors of the foreign entity in the United States will have access to the same rights and remedies against officers and directors as they would have against officers and directors of domestic
business entities.

Officers and directors of foreign business entities doing business in the United States should also understand that state and federal laws regulating the affairs of businesses generally will apply to the foreign entity and to its officers and directors. Accordingly, state and federal laws with respect to environmental regulation and protection, anti-trust, employment, wage hour laws workplace safety, consumer protection, the issuance of securities and other laws will all apply with equal force to a foreign business engaged in commerce in the United States.

QUESTION 10

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10. 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 defense costs and interpretation of the policy exclusions. Since the D&O policy is claims made, the insurer will require that the insured dictate all known claims and potential claims in the insurance application. If a claim later arises based on conduct prior to the date of the application, the insurer will likely deny coverage.

A policy application is ordinarily signed by the President of the company. Courts have held that innocent directors without knowledge of facts relating to a possible claim will nonetheless lose coverage if the corporation's President had knowledge of such a claim and failed to disclose it on the policy application. To protect against this eventuality, the company may purchase a policy with a severability provision. A policy with a severability provision means that the insurer takes a separate application from each insured officer and director and that the failure of any single officer or director to reveal facts pertaining to a potential claim will not void the coverage of an innocent insured.

QUESTION 11

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11. 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, that 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 are 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.

· **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 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 Debtor can recover certain payments made by the Debtor on account of an existing debt to an unsecured or undersecured creditor made within ninety (90) days preceding the filing. 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 favorable Plan terms. The recovery of preferential payments is governed by 11 U.S.C. section 547 and 550.

· **Why might a business entity file for relief under Chapter 11?**

- If a secured creditor is taking enforcement action to take possession of assets or to foreclose liens in real or personal property of the Debtor, the automatic stay imposed by Code sec 362 will stop such action.

- If the Debtor is unable to pay its unsecured creditors in accordance with terms and creditors are commencing collection actions and/or seeking to attach assets, Code sec 362 will force creditors to stop their collection actions.

- If the Debtor is facing costly litigation due to a product failure or warranty claims.

- If the Debtor wishes to consummate a going-concern sale of assets, but attachments or the threat of attachments makes the buyer unwilling or unable to close.

- If the Debtor needs working capital financing, but its 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.

- **Why file under chapter 11 rather than Chapter 7 or Chapter 13?**

  - Chapter 13 is only available to individuals and then only individuals whose secured and unsecured debts do not exceed a stated level. **See** Code sec. 109(e). Business entities may not use chapter 13.
  - Chapter 7 results in the appointment of a trustee whose job is to liquidate the assets of the Debtor and distribute the proceeds in accordance with the priorities set forth in the Code. A chapter 7 trustee is not ordinarily interested in operating a business. If the goal is to maintain ongoing business operations, chapter 7 is probably not a viable option.

  - Chapter 11 affords a business **an opportunity to restructure its debts** into a more feasible payment schedule**.**

  - Chapter 11 affords a business **an opportunity to sell its assets in a setting superior to a foreclosure**.

  - Absent special circumstances, a chapter 11 debtor remains in possession and control of its property. A chapter 11 debtor in possession and control of its property is known as a debtor-in-possession.

  Practice Consideration: If the principals of the Debtor have engaged in serious pre-petition fraudulent conduct, on motion of a party in interest, the Court may appoint a trustee to take possession and control of the Debtor's business in the chapter 11 proceeding pursuant to Code section 1104. Counsel are well advised to inform their clients of this possibility. Counsel are also well advised to review the other grounds for appointment of a trustee set forth in Code section 1104 in a chapter 11 proceeding.

- **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.

- **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.

- **Chapter 11 affords an opportunity to sell the assets of a going-concern free and clear of liens and claims.**

  One of the principal benefits and uses of chapter 11 is the ability to obtain a Bankruptcy Court Order under 11 U.S.C. sec. 363 authorizing the sale of a Debtor's assets free and clear of liens and claims. In this manner, a going-concern business can consummate a sale of assets free of the claims of secured and unsecured creditors. Such a Court Order may be required by a buyer so that the buyer knows that its use and possession of the Debtor's assets will not be disturbed by unsatisfied creditors of the seller. Moreover, such a Court Order may be a practical necessity to clear the assets of consensual or nonconsensual liens.

  Practice Consideration: The benefit of Code section 363 is that it allows a transaction to proceed that could not be accomplished absent the special power of the Bankruptcy Court. Valid liens and attachments attach to the proceeds of the sale in the same order of priority as they had on the assets themselves. In this manner, the property interest of the lien holder is respected: the lien is transferred from the asset to the proceeds of the asset. The lien holder, however, cannot prevent the Debtor from selling the asset. But see the next Practice Consideration.

  Practice Consideration: Lenders often cooperate with and benefit from a sale under Code section 363. After all, a secured creditor's remedy is the sale of the collateral and if the Debtor will do the job for the Bank, so much the better. However, occasionally, the Lender will argue that the purchase price for the sale of the Debtor's assets is too low. In that context, the Court may permit the Lender to credit-bid for the assets. See Code sec. 363(k). A successful credit-bid by the Lender will, of course, prevent the going concern sale from proceeding. The burden is on the Debtor and its counsel to convince the Lender that the price offered for the assets is more than the Lender would receive if the Lender foreclosed its liens.

- **Chapter 11 affords an opportunity to obtain financing on a senior secured basis.**

  Under Code section 364, a debtor may borrow money and grant a lien that takes priority over the lien of existing secured creditors. The Bankruptcy Court will only authorize a priming lien if the Debtor demonstrates that the interests of existing creditors in the collateral are adequately protected. If the Debtor has equity in its existing assets or if the Debtor requires debt to acquire new assets post-petition, the combination of Code section 552 which cuts off floating liens and Code section 364 which permits post-petition secured borrowing can enable a Debtor to achieve its short term goals of access to debt financing notwithstanding a lack of cooperation from existing lenders.

· **The plan of reorganization.**

The Plan of Reorganization is the legal document that describes the treatment of the pre-petition claims against the Debtor. The Code provides that the Debtor shall divide the pre-petition claims into classes of like claims. 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 usually comprise a single class. Accordingly, the Plan describes the various classes of claims and the treatment afforded those classes by Debtor.

Classification is important because (i) all claims in the class receive the same treatment 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 favor of a Plan (and all claims in the class are bound by the Plan) if a majority of the holders of claims in the class who actually cast ballots vote in favor of the Plan and, of those who vote, if the holders of claims totaling two-thirds in dollar amount vote in favor of the Plan.

1. Confirmation 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 favorably 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. 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 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 prepetition, unsecured tax claims against the Debtor, including income, sales and withholding taxes, must be paid in full under the Plan, with interest, over no more than six years.

Section 1129(a)(10) contains the requirement that if a class of claims is impaired under the Plan, at least one class of impaired creditors has approved the Plan. This is the "somebody has to think it's a good idea test".

Section 1129(a)(11) contains the requirement that the Court determine that the confirmation of the Debtor's Plan is not likely to be followed by the further financial reorganization of the Debtor. In other words, the Court must determine that the Plan is feasible.

2. The absolute priority rule.

Section 1129(a)(8) required that each impaired class accept the Plan. Section 1129(b), however, sets forth those circumstances under which the Court may confirm a Plan notwithstanding the Debtor's failure to satisfy the requirement of 1129(a)(8). Section 1129(b) provides that the Court may confirm the Plan notwithstanding the failure to comply with (a)(8) provided the Plan is fair and equitable and does not discriminate unfairly.

Fair and Equitable with respect to a class of secured claims, means that the Plan cannot be confirmed over the objection of an impaired class of secured claims unless (i) the secured creditor retains its interest in the property of the Debtor and (ii) the secured creditor receives under the Plan deferred cash

payments with a present value at least equal to the value of the secured creditor's interest in the Debtor's property.

Assume a class containing a single claim held by a secured creditor with a first priority lien on the Debtor's machinery and equipment. Assume the claim is in the amount of $500,000 and the property of the Debtor is worth more than that amount. Assume also that the claim is impaired because the Debtor is going to increase the term of the payout. If the holder of the claim votes against the Plan, the Debtor may still confirm the Plan provided that the Plan provides that (i) the secured creditor retains its lien on the property and (ii) the Debtor will pay an amount over time equal to the present value of the secured creditor's interest in the property. This means simply that the Debtor must provide the creditor a stream of payments worth $500,000. The only way this can be done is with a market rate of interest added to the $500,000 payment.

Assume now that the creditor's claim is $500,000, but the value of the collateral is only $300,000. In this context, the Plan may be confirmed over the objection of the creditor holding the secured claim by means of a Plan that (i) allows the creditor to retain its lien and (ii) pays the creditor an amount over time with a present value of $300,000.

Practice Tip: Confirmation of a Plan over the objection of a nonconsenting, 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 fulfill the Plan terms. Of course, disagreement over the applicable interest rate necessary to achieve the correct present value is also possible.

Fair and Equitable with respect to a class of unsecured claims, means that 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. Generally, if equity is to remain in place, the equity holders must negotiate with the unsecured creditors to obtain the consent of the unsecured class.

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